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Market Structure

Liquidity Landscape

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Liquidity Landscape: One month post-Brexit

As the industry adjusts to the post-Brexit reality, the trading of EU instruments has switched to EU domiciled venues relatively seamlessly. However, with the MiFID II Review due later this year, questions remain as to what impact this will have on the UK and EU trading landscape. Liquidnet has analysed the first month of trading data to establish what we know so far.

1. One month into Brexit

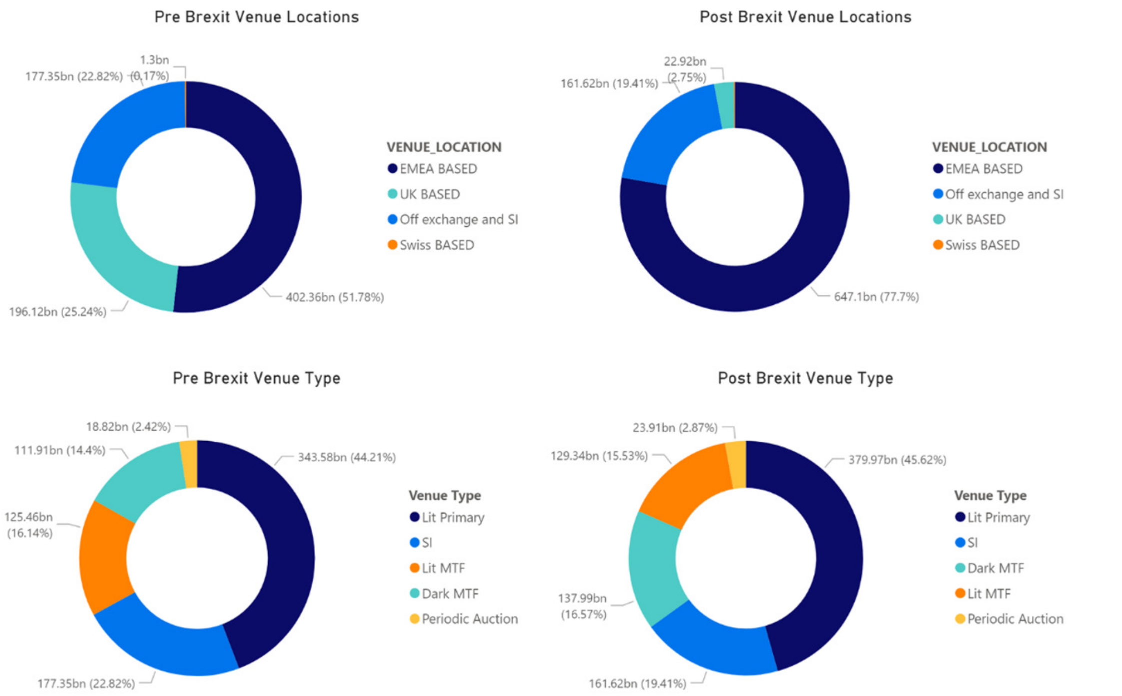
One month into Brexit and the liquidity landscape remains relatively stable. As predicted in our first report,[1] the proportion of activity in EU STO stocks traded on UK based venues continued to decline as initial routing challenges were addressed; representing just 2.75% of EU addressable liquidity compared to 25% pre-Brexit (*see Exhibit 1*).

While the dislocation of EU liquidity seems unlikely to reverse given the investment trading venues have made in setting up platforms in the EU, regulators will continue to look closely at how liquidity forms and in particular, levels of dark and OTC trading. First month data shows the market share of primary exchanges at 46% and lit MTFs at 16% compared to 19% for SIs, 17% for dark MTFs and 3% for periodic auctions. The question mark remains as to where the Off-Exchange OTC activity is taking place and whether European regulators will be satisfied with OTC/SI activity representing a fifth of daily volumes.

ESMA indicated its concern regarding the use of the SI to match clients order flow between the EU and the UK in its recent update to the Market Structure Q+A.[2] The regulator reiterated that SIs are characterised by risk facing transactions and they should be able to demonstrate the “inherent financial risk” they are taking. This is a reminder for the industry in light of market developments post-Brexit that SIs should not bring together third-party buying and selling interests and should not consist of an internal matching system which executes client orders on a multilateral basis—activities that require authorisation to operate as an MTF.[3]

Exhibit 1

Pre- vs Post-Brexit venue locations for EU STO stocks only including addressable liquidity



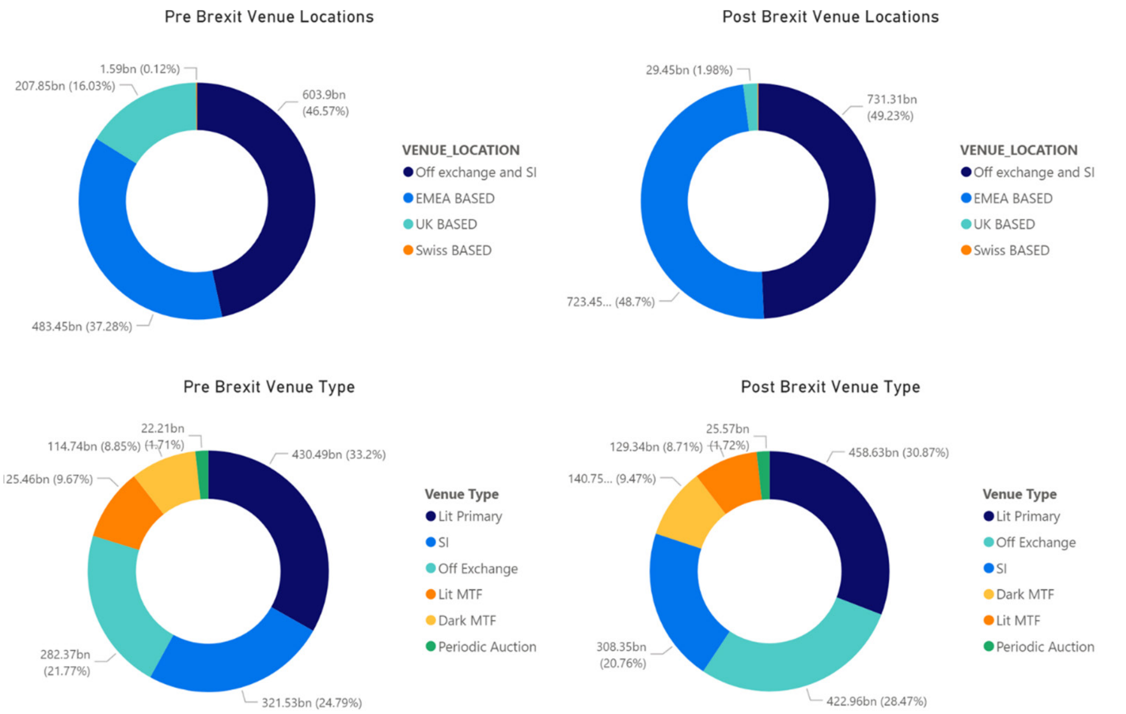
Source: Bloomberg

1 https://bit.ly/2Luat8S
2 https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-38_qas_on_mifid_ii_and_mifir_market_structures_topics.pdf
3 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0565&from=EN

The share in OTC and SI is higher if we also include non-addressable liquidity, from 46% to 49% post-Brexit (*see Exhibit 2*). This discrepancy highlights the remaining challenge with the SI construct with trades reported under one unique MIC—SINT, which prevents market participants from knowing the firm in question or the location of the SI, whether the trade is from an EU or UK SI. Although the industry is endeavouring to improve transparency, understanding the routing logic behind the SI activity as well as how the SI determines addressable and non-addressable liquidity remains a challenge.

Exhibit 2

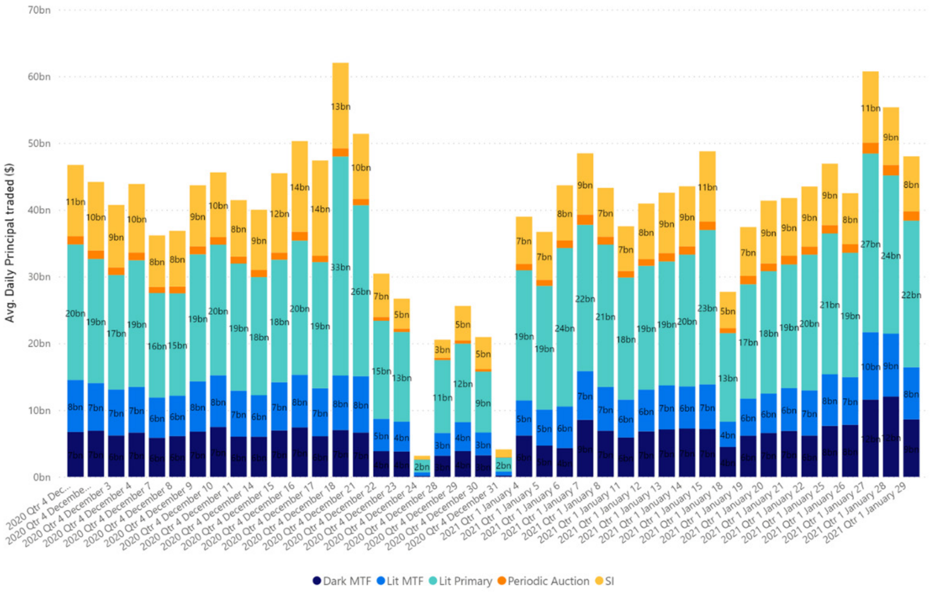
Pre- vs Post-Brexit venue locations for EU STO stocks including addressable and non-addressable liquidity



Source: Bloomberg

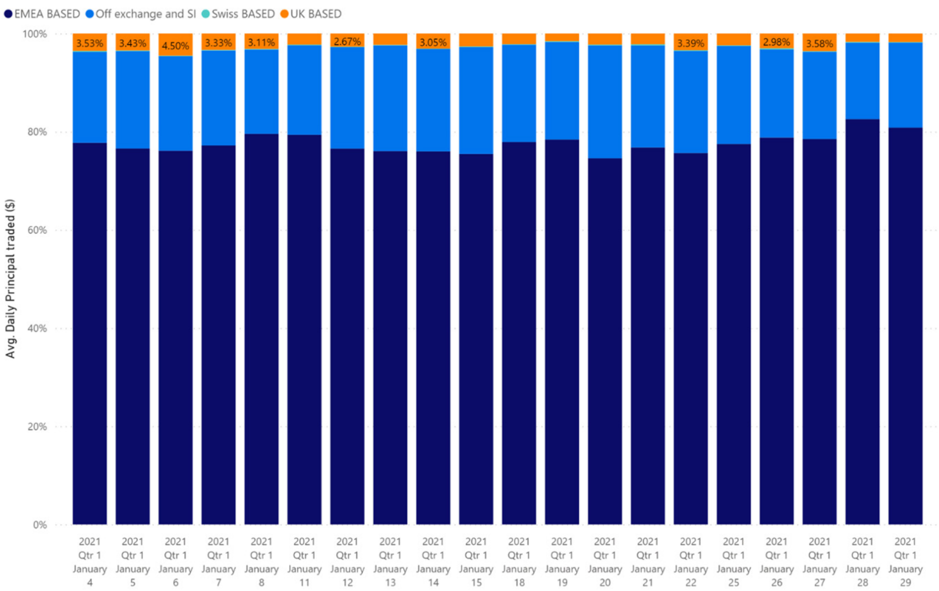
In addition, the breakdown in market share between venue types remained similar, looking at both EU and then all EU and UK activity, market structure has hardly changed pre- vs post-Brexit (*see Exhibits 3 and 4*).

Exhibit 3
Trading Pre- and Post-Brexit–EU STO stocks by venue type (interactable flow only)



Source: Bloomberg

Exhibit 4
Trading Pre- and Post-Brexit–EU STO stocks by venue location (interactable and non-interactable flow)



Source: Bloomberg

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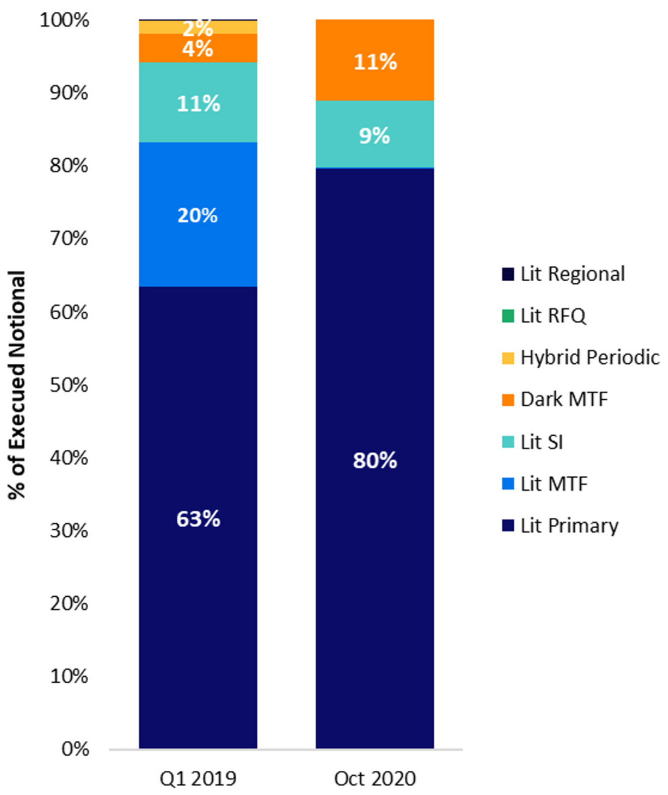
2. Swiss equivalence

On February 3, the UK granted Switzerland equivalence and in return, Switzerland lifted any restrictions on the UK[4] allowing UK trading venues to re-list and trade Swiss instruments on their platforms. One area to watch is how the Swiss SIX Exchange will respond to increased competition from UK venues as well as the impact the new equivalence will have on liquidity, spreads and the cost of trading for Swiss instruments. In the first quarter of 2019, prior to the suspension of Swiss equivalence, 63% of volumes in Swiss names happened on the Swiss Lit primary, compared to 20% on lit MTFs, 11% on SIs, 4% on dark MTFs, and 2% for periodic auctions. In October 2020, the liquidity landscape was very different with 80% of volumes traded on the Swiss lit primary, and SwissAtMid (the Swiss equivalent of dark MTF) absorbed all the dark flow representing, 11% of activity in Swiss equities. Only 9% of volumes were executed on SIs. The question is whether the UK volumes that ended up on SIX lit and dark markets will return or if a new equilibrium will be found.

Exhibit 5

Trading in Swiss names pre- vs post-suspension of equivalence



Source: Bloomberg

Any new equivalence regime will reinforce European concerns that they could be placed at a disadvantage with UK and US firms able to execute on UK and Swiss venues. If a significant amount of volume flows back to the UK, Europe will likely take actions and reconsider their approach to delegation and outsourcing arrangements.

There remains strong support across Europe to revisit delegation arrangements. In August 2020, ESMA has requested legal clarification[5] from the European Commission in relation to the extent of delegation including a list of core or critical functions that must always be performed internally and may not be delegated to third parties. The European regulator recommended addressing substance and delegation regimes as one of the priority topics in the forthcoming AIFMD review.[6] Europe also announced plans to ramp up staffing resources needed to apply new rules for third-country firms under MiFIR.[7]

4 https://www.six-group.com/en/newsroom/media-releases/2021/20210203-ch-uk-equivalence.html
5 https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf
6 https://www.esma.europa.eu/press-news/esma-news/esma-recommends-priority-topics-in-aifmd-review
7 https://www.esma.europa.eu/press-news/esma-news/esma-reports-resources-and-staffing-it-will-need-apply-new-rules-third-country

3. Things to watch in 2021 with the MiFID II/R review

Although the liquidity landscape post-Brexit has not yet significantly changed, 2021 is set to be a busy year from a regulatory perspective. There is a number of unresolved issues in Europe that will likely be addressed in the forthcoming MiFID II/R review expected in the second half of this year, the outcome of which could alter liquidity formation on both sides of the channel.

Dark trading and periodics

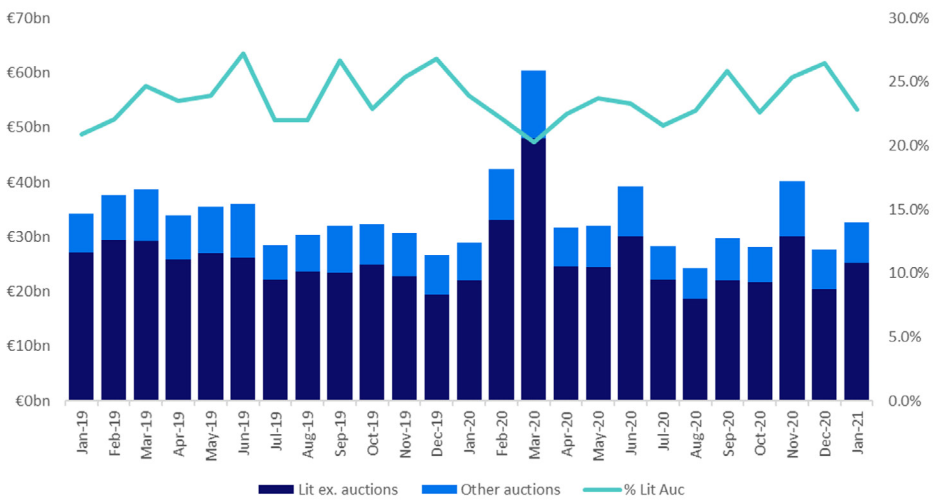
Further constraints on dark trading and periodic auctions are anticipated in the review given previous guidance.[8] Questions remain as to whether the Reference Price Waiver (RPW) will be maintained and its threshold increased or if it will be removed allowing only LIS orders to be executed in the dark.[9] However, given the FCA's decision to lower the LIS threshold for stocks with the primary listing in the EU to just €15,000 and the UK's continued support for dark MTFs and periodic order types, any decision from the EU to further curb the use of these trading mechanisms risks to negatively impacting the EU market structure, with liquidity potentially gravitating back to the UK. The unanswered question is what measures EU regulators will take to prevent this from happening—with reverse solicitation,[10] delegation of portfolio management and outsourcing of services[11] to third-party firms all still on the table for discussion to avoid disadvantaging both European asset managers and their end investors.

Closing auctions

Volume at the close continues to rise, partly due to the increase in passive investing, but also due to asset managers participating in concentrated liquidity points at the open, the US open and at the close exacerbating the rise in closing volumes (*see Exhibit 6*). A recent study published by Euronext[12] confirmed that cost plays a role in making closing auctions a popular mechanism. For example, an order representing 3% of ADV would cost 3.7 bps if traded at the close versus 13.9 bps during continuous trading hours. Given that the close now represents the main liquidity event of the day, we can anticipate further guidance on trading initiatives arising around the close to ensure effective and strong price formation, following from previous ESMA guidance.[13]

Exhibit 6

Lit volumes and percentages



Source: Bloomberg

8 https://www.esma.europa.eu/sites/default/files/library/esma70-156-2682_mifidii_mifir_report_on_transparency_equity_dvc_tos.pdf
9 https://www.esma.europa.eu/press-news/esma-news/esma-publishes-annual-report-application-waivers-and-deferrals-equity
10 https://www.esma.europa.eu/press-news/esma-news/esma-reminds-firms-mifid-ii-rules-reverse-solicitation
11 https://www.esma.europa.eu/sites/default/files/library/esma34-32-551_esma_letter_on_aifmd_review.pdf
12 https://www.euronext.com/en/quant-research
13 https://www.esma.europa.eu/sites/default/files/library/esma70-156-2682_mifidii_mifir_report_on_transparency_equity_dvc_tos.pdf

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Exchange outages

While exchanges proved resilient at the height of the pandemic, the outages and related disruptions in the second half of 2020 have led to industry demands for greater regulatory action. Unlike the US system where orders can be sent to other venues to be traded, in Europe, an outage means trading is halted—sometimes for several hours and across multiple EU countries within an exchange network. One area of review is the definition of what constitutes the most relevant market under MiFIR that reinforces the use of primary exchanges' market data as a single reference point with trading algorithms pegged to the Primary Best Bid and Offer. One solution put forward by market participants would be for algos to be pegged at the European Best Bid and Offer, which would allow the market to trade on alternative venues should an outage happen to ensure continuity of trading. This issue is also raised as part of the algorithmic trading consultation paper launched by ESMA[14] in December where trading algorithms could be required to use more than one reference data point.

A level playing field

Both the European Commission and ESMA are now looking at levelling the playing field between regulated and non-regulated activity. Although this issue is of more immediate concern to fixed income trading rather than equities, this could have implications for technology providers in terms of what is deemed acceptable unregulated activity. This could lead to changes in how trading systems are able to operate from a voice and venue perspective.

While Liquidnet is fully supportive of the regulatory objective of greater transparency and the importance of a level playing field, concerns remain as to the wider full market impact of encompassing technology systems in the definition of regulated activity. Ideally broader discussions with the buy-side and technology providers need to take place to understand these impacts before any changes are made to regulations which could negatively impact the capacity for the market to innovate and provide technology solutions.

Market data and consolidated tape

Another area of focus for regulators is the continued rise of market data cost and the complexity of licensing agreements that are forcing some market participants to select datasets that are only essential to their day-to-day operations and prevent them from further automating the investment process, which would require more data. This has led to greater regulatory focus on the implementation of a European consolidated tape for equities and bonds and is likely to be included in the MiFID II/R review this year.

We will keep you updated.

14 https://www.esma.europa.eu/sites/default/files/library/esma-70-156-2368_mifid_ii_consultation_paper_on_algorithmic_trading.pdf