

Liquidity Landscape

May, 2021

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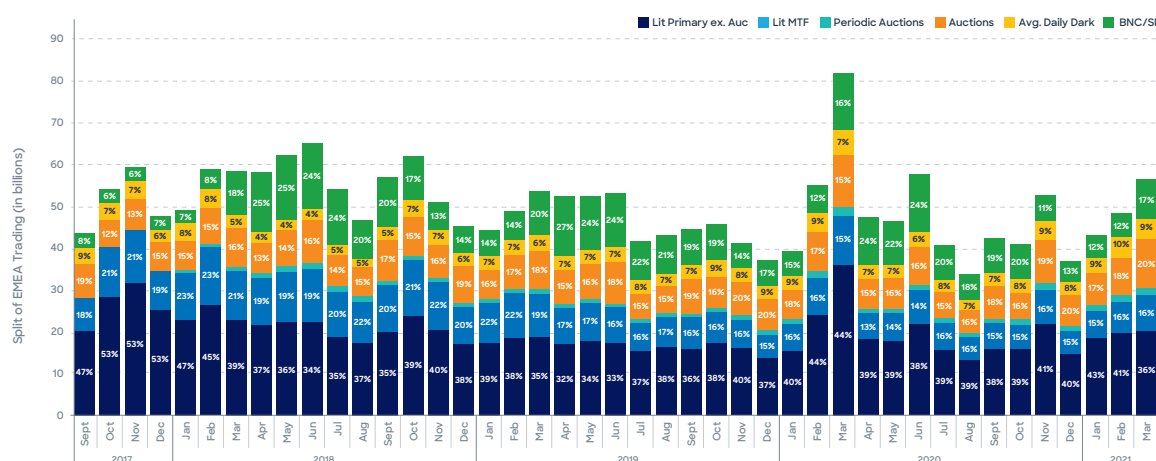
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Liquidity Landscape: Q1 2021

Despite some moderate fluctuations in the market share of auctions and SIs, the post-Brexit liquidity landscape continues to be stable with daily volumes traded averaging €56B in March up from an average of €43B in Q4 2020 (see *Exhibit 1*). However, the regulatory agenda for 2021/22 is set to keep the industry busy for near future, with the intention to revisit financial regulation both in the EU and the UK. The recent announcement by HM Treasury¹ to remove the Share Trading Obligation and the Double Volume Cap emphasizes the extent to which initial divergence appears inevitable. The FCA kicked off a series of consultation papers (CP) in April with the Conduct and Organisational requirements.² This will be followed by the Wholesale Markets Review in June, and then the MiFID/R review from ESMA CP in July, which will focus on proposed changes to RTS 1 and 2.

Exhibit 1

EMEA monthly market share 2018 to date



Source: Bloomberg

What to expect from Europe?

The MiFID II review

The MiFIR/MiFID II impact assessment is currently being completed by the EU Commission, ESMA will then consult in July and make their proposals in Q1 2022.

The focus will be on ensuring data quality and common standards to improve disclosures and transparency. Following a series of exchange outages over the past 18 months, European regulators are looking at new ways to improve investor confidence in accessing lit markets through the adoption of a consolidated tape as well as linking license authorization to the quality of data provided to the tape.

The political drive to increase volumes traded on lit markets remains and could be achieved by mandating smaller tickets be traded on regulated markets only. Although the share of dark MTFs as a percentage of dark and lit volumes remains firmly under the bar of 8% (see *Exhibit 2*), further constraints on dark trading and periodic auctions are anticipated in the review given previous guidance.³ Questions remain as to whether the Reference Price Waiver (RPW) will be maintained with an increased threshold, or if it will be removed in its entirety, allowing only LIS orders to be executed in the dark.⁴ This contrasts with the view held by the FCA who highlighted in their recent paper⁵ the benefits to performance from trading in the dark.

¹ <https://www.gov.uk/government/news/ambitious-plans-to-boost-uk-fintech-and-financial-services-set-out-by-chancellor>

² <https://www.fca.org.uk/publications/consultation-papers/cp21-9-changes-uk-mifid-conduct-organisational-requirements>

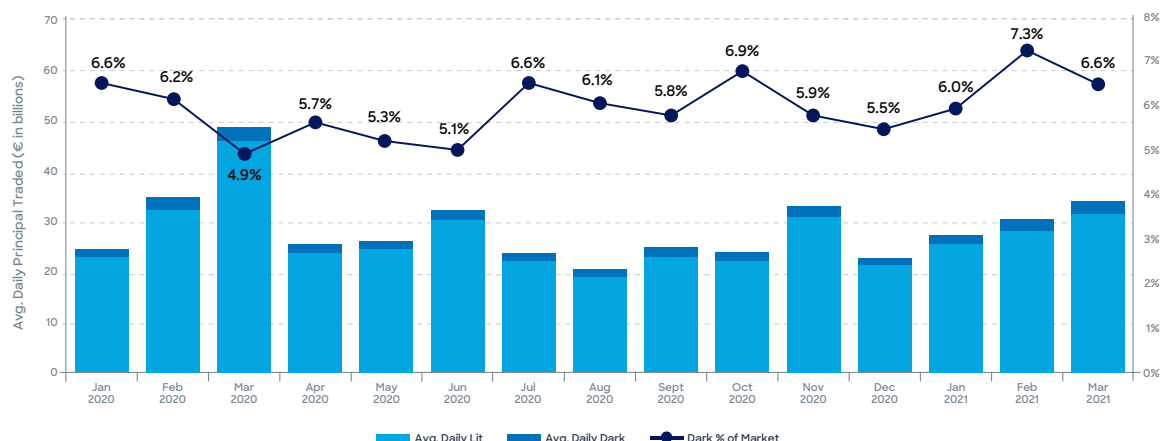
³ https://www.esma.europa.eu/sites/default/files/library/esma70-156-2682_mifidii_mifir_report_on_transparency_equity_dvc_tos.pdf

⁴ <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-annual-report-application-waivers-and-deferrals-equity>

⁵ <https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-60-banning-dark-pools-venue-selection-and-investor-trading-costs>

Exhibit 2

Dark % of dark and lit volumes in Europe



Source: Bloomberg

Level playing field

A number of issues relating to the level playing field have emerged since the introduction of MiFID II, one of which being the definition and differences that separate multilateral and bilateral systems. In a recent paper,⁶ ESMA made clear they have no intention to capture any bilateral systems and bring them into the scope of multilateral, however they also put forward several suggestions aiming to close the gap that may exist in the market. The first proposal is to move Article 1(7) of MiFID,⁷ which state that all multilateral systems need to operate either as MTFs, OTFs, or RMs, from the Directive to regulation under MiFIR to prevent any divergence in the transposition of the article into national law. ESMA reiterates that a multilateral system is characterized by allowing multiple third-party trading interests to interact within a system. Yet, this also appears to include information exchange between parties about the terms of a transaction such as the price and quantity, which would then require the “communication” system to register as a venue. ESMA also state that the exchange of information does not necessarily need to result in a contractual agreement to potentially fall in the scope of multilateral systems subject to registration as a trading venue.

The proposal could create shockwaves across the industry as it potentially would encompass a number of technology providers such as OMSs and EMSs that are deemed essential to the buy-side to find liquidity. ESMA has indicated its intention to provide greater guidance on the definition and principals underlying multilateral systems via an Opinion Paper.⁸ It also intends to launch a public consultation to gather further feedback on what systems should be considered “multilateral.” However, the European regulator was already clear in its OTF paper that multiple bilateral interactions are not necessarily exempt from the need to be authorized as a trading venue. Finding a common ground among all market participants will be challenging given the current divergent interests in the industry. Nevertheless, the more restrictive the definition becomes, the more it will hinder innovation at a time where more than ever further digitalization and electronification of workflows to achieve greater efficiencies is critical.

SI concerns remain

ESMA have also noted their concern regarding the ability to accurately establish the proportion of OTC activity versus on-venue. Following the introduction of MiFID II and the expansion of the SI regime, ESMA continue to highlight their concerns regarding the development of arrangements that facilitate execution between multiple buyers and sellers without being authorized as a RM, MTF, or OTF. The continued use of generic identifier SINT and reporting many trades via XOFF makes understanding addressable liquidity difficult for all market participants. The perception is that SIs continue to enter into matching arrangements with entities outside their own group to carry out riskless back-to-back transactions, which ESMA consider to be against the “spirit” of MiFID II, potentially circumventing post-Brexit rules. This underpins concerns that broker crossing network activity appears to have shifted to SIs and increased, rather than moving to authorized venues as anticipated.

⁶ https://www.esma.europa.eu/sites/default/files/esma70-156-4225_mifid_ii_final_report_on_functioning_of_otf.pdf

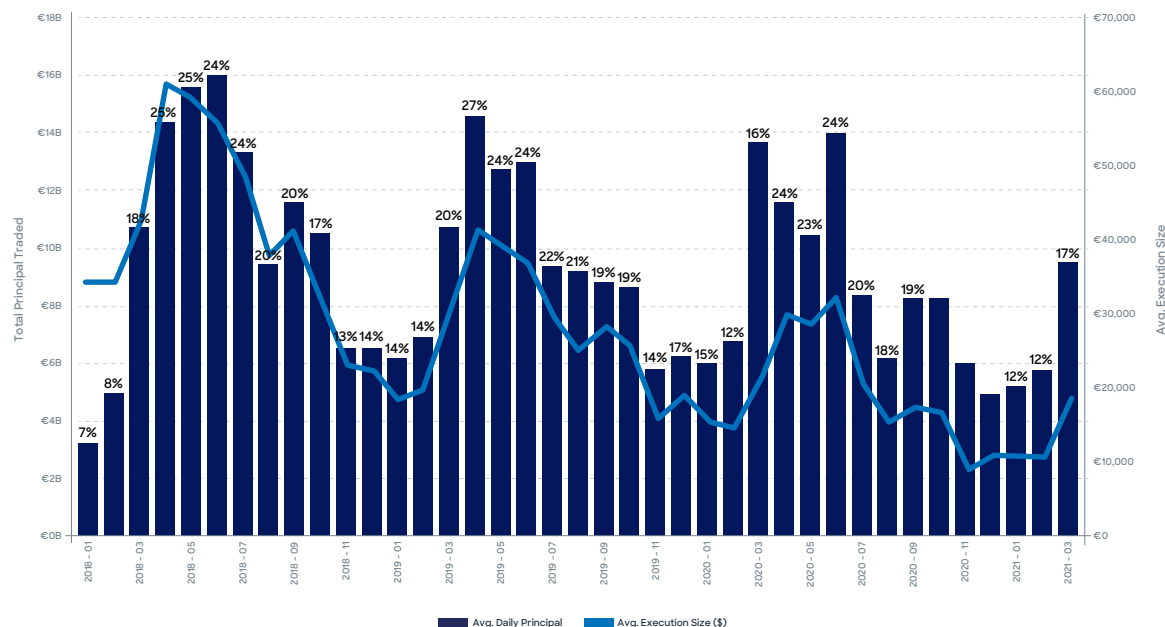
⁷ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN>

⁸ https://www.esma.europa.eu/sites/default/files/esma70-156-4225_mifid_ii_final_report_on_functioning_of_otf.pdf

ESMA believe their clarifications in the SI report⁹ are sufficiently clear and delineate what is understood to be acceptable SI activity. As such, ESMA does not intend to propose any further amendments. However, as SIs continue to represent almost a fifth of overall activity in Europe (see *Exhibit 3*) further amendments to the current rulebook appear necessary to curb SI activity, in particular the potential to limit SIs to LIS only, which would result in a significant change in liquidity formation in Europe.

Exhibit 3

SI Average Daily Principal traded by month



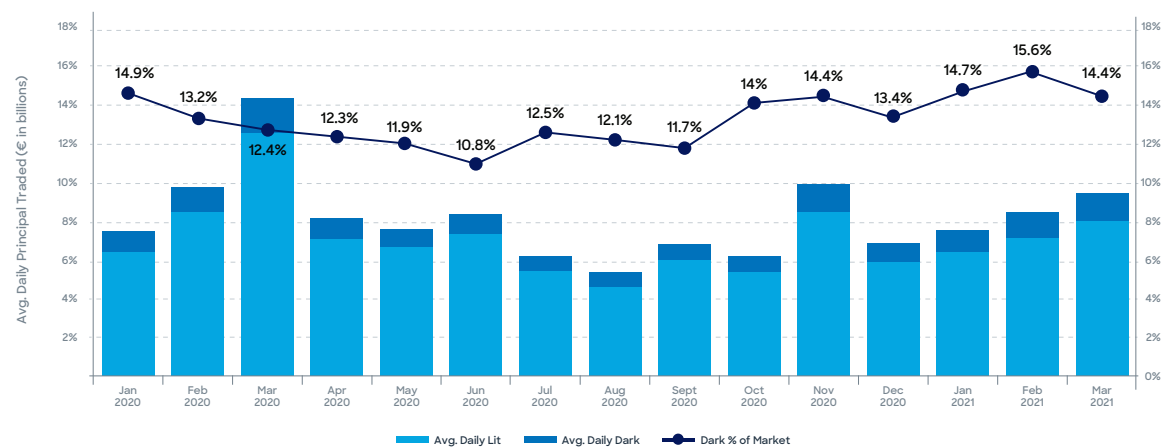
Source: Bloomberg

The UK response

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, already highlight the potential future divergence from EU rules and resulted in an uptick in dark activity in the UK (see *Exhibit 4*). The FCA went even further by stating that the DVCs will not automatically be applied¹⁰ and that dark activity up to 15% of total volumes will be considered acceptable—a strong departure from the EU's view, which set the threshold for dark trading at 7%.

Exhibit 4

Dark % of dark and lit volumes in UK Stocks



Source: Bloomberg

⁹ https://www.esma.europa.eu/sites/default/files/library/esma70-156-2756_mifidii_mifir_report_on_systematic_internalisers.pdf

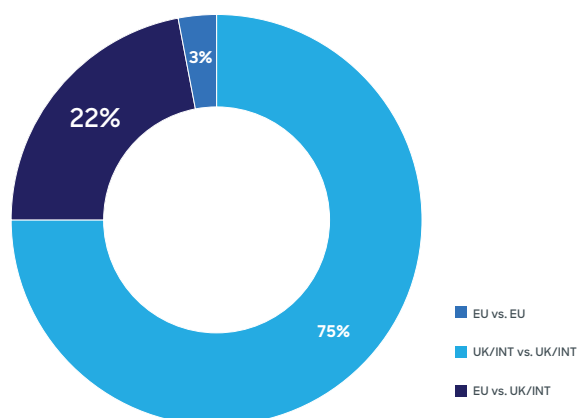
¹⁰ <https://www.fca.org.uk/news/statements/update-double-volume-cap>

Given the UK's plan to conduct a full wholesale market review starting in June with the aim to streamline existing regulation we are likely to see further regulatory change both sides of the channel. With the UK's position on dark trading, some divergence appears inevitable, but it is also worth noting the regulatory need to operate in tandem to ensure one jurisdiction does not have an advantage over the other. After the EU decision to rebundle research for SME coverage, the UK has also announced their proposal to rebundle, albeit for SMEs with a market capitalisation of up to £200M rather than €1B.¹¹ The FCA acknowledge that research alone will not solve the SME conundrum and liquidity needs to be taken into consideration. Low research coverage often affects micro and small companies where volumes traded remain thin, making it uneconomical for the sell-side to support research to maintain liquidity. Both the UK and EU have indicated their intention to make further regulatory changes regarding trading conditions for SMEs to improve access to capital markets.

The next question is how will the EU decide to respond to the UK's removal of the STO. By allowing asset managers to trade wherever they see fit with their US and Swiss counterparts, European asset managers will be potentially at a disadvantage, excluded from pools of liquidity. The risk is particularly apparent given 75% of trading occurs between UK and International Institutional counterparties versus 25% including EU Asset Managers (see *Exhibit 5*). With the ESMA CP due out in July there are question marks over whether the STO and DVC will be reviewed as a result; will it be a race to zero or will the EU revert to "fortress Europe"?

Exhibit 5

Counterparty locations—Executions in Liquidnet for 45 Dual-listed Stocks Apr 1 – Sept 23, 2019



Source: Liquidnet data. Executions in 45 names between April 1, 2019 and September 23, 2019.

The next round of Consultations in the summer will be extensive as they are set to include topics such as primary listings, transparency, market data—including discussions around a Consolidated Tape, commodity derivatives, new technology, and unregulated system providers and will be likely to initiate further response from both sides. While the regulatory landscape remains in a state of flux, the industry will need to brace itself for continued change ahead as the full effect of Brexit has yet to be felt.

¹¹ <https://www.fca.org.uk/publications/consultation-papers/cp21-9-changes-uk-mifid-conduct-organisational-requirements>

