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Market Structure

Liquidity Landscape

Q3 2022

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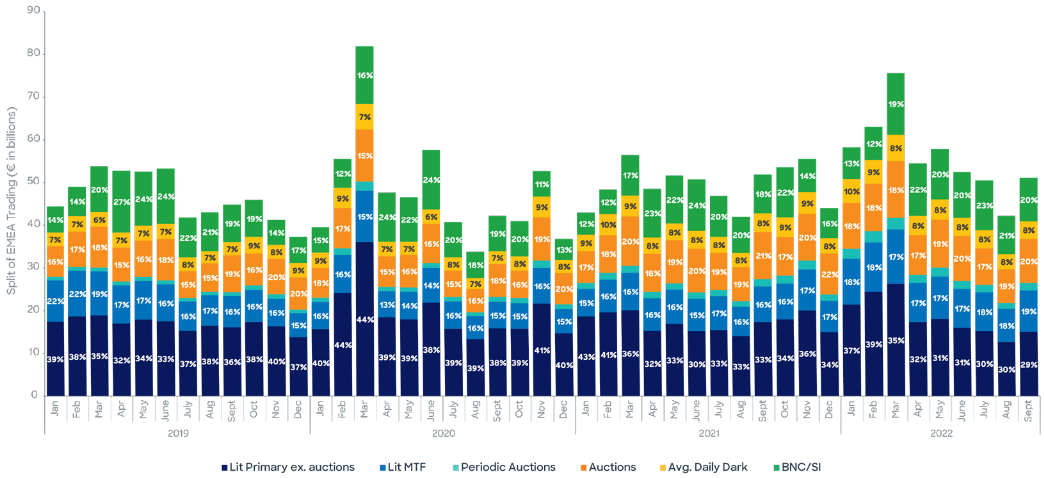
European Liquidity—Calm Before the Storm?

Post the brief interlude of Trussonomics, a period of relative calm is settling on markets in terms of regulatory change. Pragmatic convergence between European and UK regulators is looking more likely but while market participants both sides of the channel are keen to reduce fragmentation and mitigate operational complexity—the harsh reality is the European policy to increase liquidity formation on primary public markets continues to remain elusive, indicating further policy intervention is inevitable. Lit primary trading excluding auctions has now fallen to its lowest level, accounting for just 29% of notional (*see Exhibit 1*).

Exhibit 1

Breakdown of European Flow



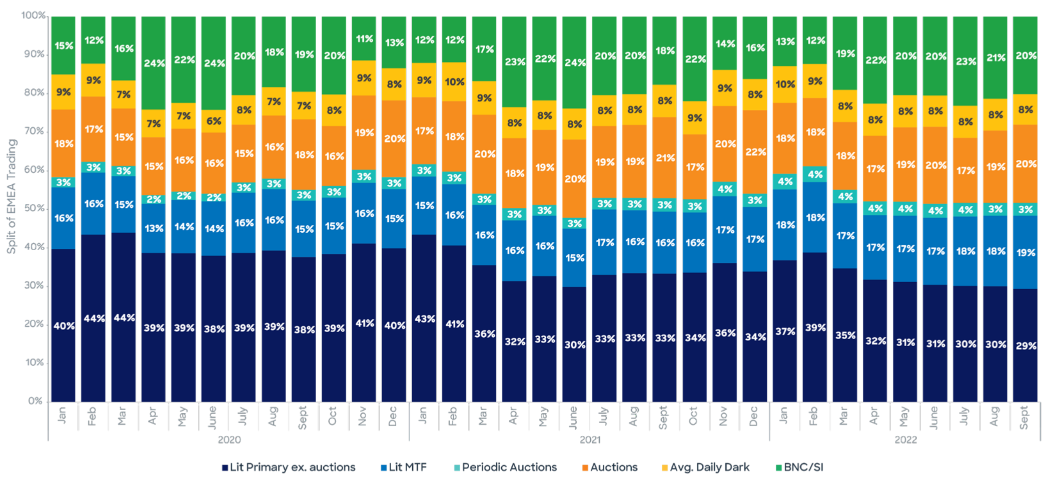
Source: Cboe Market Data and Bloomberg Data, January 2019 – September 2022

Since the introduction of MiFID II, Lit primary volumes (excluding auctions) averaged 38%. In the last six months of this year volumes have dropped to 30%. Lit Primary venues, including auctions and Lit MTFs have represented 67% of all activity in the past six months, versus 74% plus during 2018-2020.

Historically the debate has focused on Lit versus Dark. Yet the combination of Systematic Internalisers and dark venues account for approximately only a quarter to a third of the notional traded in September (*see Exhibit 1*). Instead, we have gradually seen an increase in Lit MTF activity. From an average of 14.9% in 2020, this has gradually increased to 18.4% in the last three months of 2022 (*see Exhibit 2*). Together with an increase in periodics touching 4% share of overall volumes, on venue activity has increased—just not all on the primary exchanges.

Exhibit 2

EMEA Activity since 2020

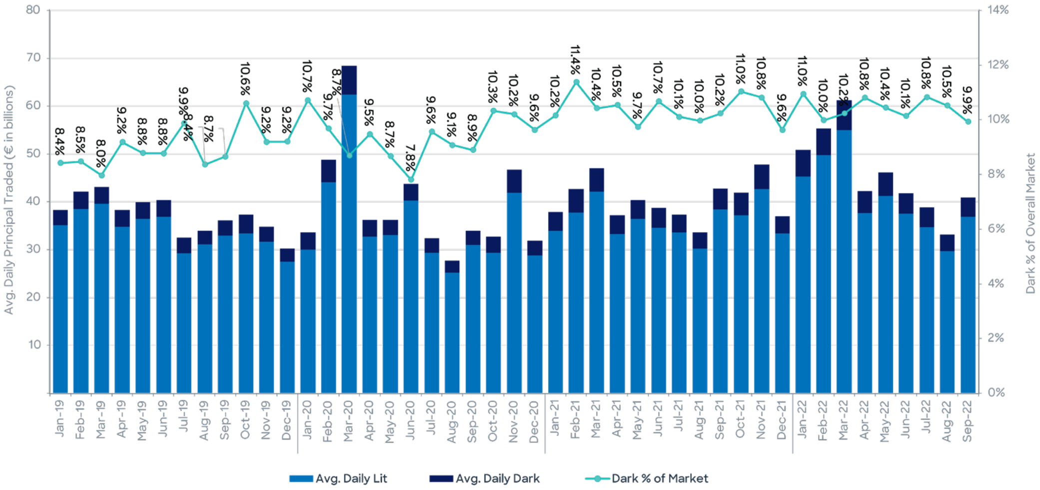


Source: Cboe Market Data and Bloomberg Data, January 2020 – September 2022

In comparison, dark trading has now steadied with the percentage of overall volume now at between 9-10% of all EU on exchange activity (*see Exhibit 3*).

Exhibit 3

Dark Trading

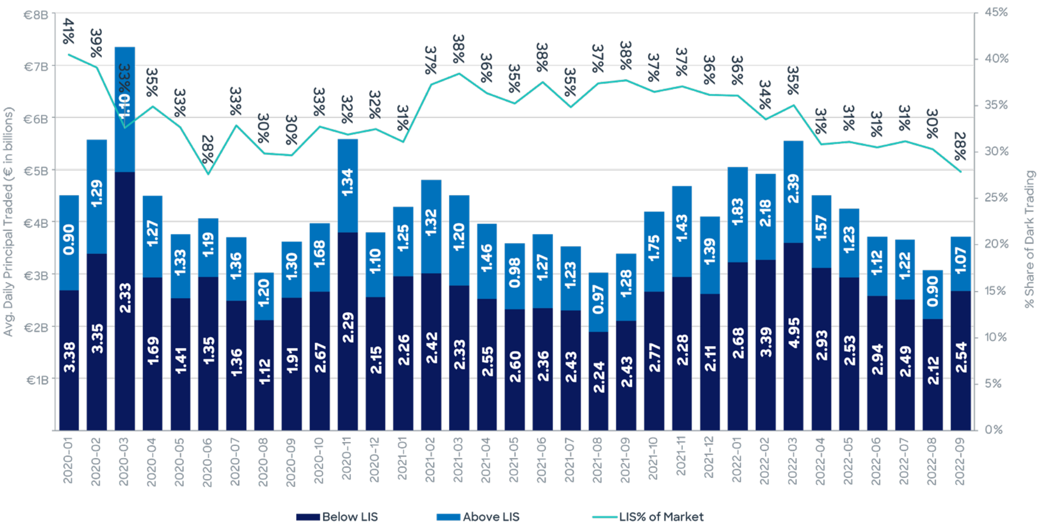


Source: Cboe and Bloomberg, January 2019 – September 2022

Necessary certainty of execution means that dark trading is only ever suitable where it is possible to wait for price improvement. However, the formation of dark activity is changing. The percentage share of dark trading greater than Large in Scale (LIS) has steadily fallen throughout 2022, seeing its lowest level of 28% in September (*see Exhibit 3*). In 2021 the LIS market was on average 36% of the dark market, compared to just 30% between April and September 2022. The comparison is even more stark when looking back to the peak of the Double Volume Caps during 2018, when the LIS market was on average 39% of the dark market and peaked at 52% in August 2018.

Exhibit 4

Large in Scale (LIS) as a Proportion of Dark Trading



Source: Cboe and Bloomberg, January 2020 – September 2022

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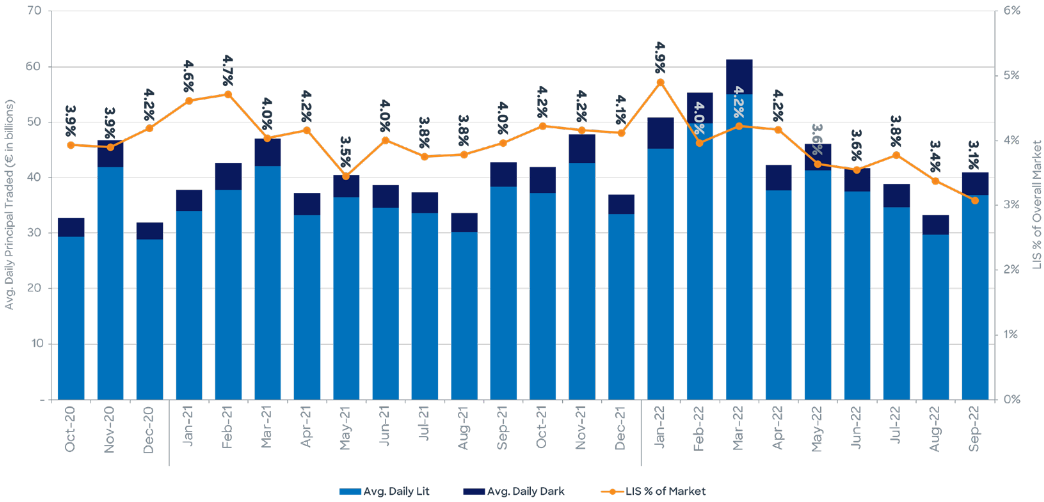
LIS activity as a percentage of overall market is at its lowest levels since MiFID II at 3.1% (*see Exhibit 5*). With the Double Volume Cap becoming irrelevant and even non-existent in the UK, along with confusion over dual LIS calculations, there is an argument that this is now too complex to manage from an operational perspective.

Exhibit 5

LIS Market: % of on-exchange activity



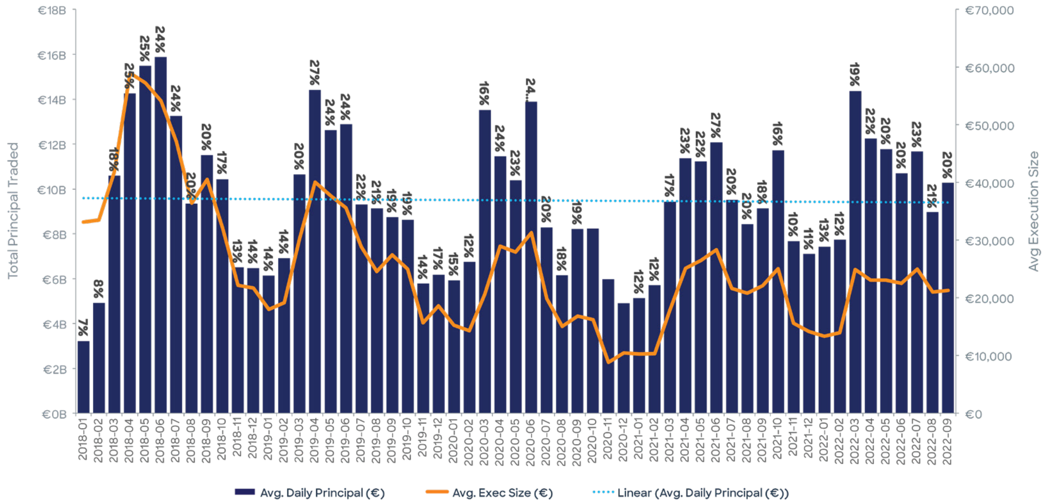
Source: Cboe and Bloomberg, January 2020 – September 2022

Any alternative to Lit

Rather than LIS liquidity being too complex, the reality is more likely due to asset managers needing to turn to other sources of available liquidity. The SI activity is increasingly being driven by new electronic market making firms such as Optiver and XTX. These firms are offering liquidity to asset managers bilaterally, and in often cases, in larger size than public lit markets but still significantly lower than LIS (*see Exhibit 6*). The need to trade more frequently in smaller clips, together with the increase in the number of liquidity providers adds to the complexity in sourcing liquidity in more sporadic intraday trading volumes.

Exhibit 6

Proportion of SI volumes and average execution size



Source: Bloomberg, January 2018 – September 2022

What this means for the Buy Side

Greater fragmentation with increased complexity means buy-side traders need to better understand where and how liquidity pools and how best to engage with liquidity when it is available. Strategies increasingly need to be adjusted mid-flight and over multiple days requiring greater knowledge of routing strategies and comprehension of how broker algos work, along with better information pre-trade to incorporate automated execution strategies.

Yet this operational need is increasingly exactly at the time when regulators across the globe have growing concerns regarding the use of AI and machine learning in technology. While looking to preserve increased digitalization of trading flow, regulators note the need to protect the integrity of markets by reviewing the distinction between technology as a means of communication versus quasi venue activity.

The FCA intends to provide greater certainty on permissions required and further guidance on how the regime is applied consistently under PERG.[1] There are clear delineations for systems which the FCA does not view as operation of a multilateral system, namely Investment-based crowdfunding firms operating primary market platforms, bulletin boards, blocking onto trading venues or execution of trading interests including arranging phone orders. However, there are still grey areas between technology providers communications systems and multilateral trading systems. For example, the FCA state that voice broking can be considered multilateral activity when operating in conjunction with other modes of execution such as electronic order books.

Execution Management

Originally ESMA's view was that any 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, including EMS.[2] However, further discussions suggest that ESMA is focused on carving out digitalized execution management from multilateral activity focusing on a concept of what the "system" allows the user to do in terms of gathering trading interests versus negotiation of trades.

Where ESMA is focusing their attention is on the increased risks from greater use of AI in trading and market participants perceived lack of knowledge. With machine learning algos more susceptible to manipulation and inadvertent spoofing, European regulators are looking at the risk of wider systemic impact from procyclicality and negative feedback loops given the interconnectedness of markets. With trading firms often more focused on performance rather than in depth knowledge of how broker algos work, future guidance on potential issues for compliance teams under RTS 6 is likely. In future, comprehension from broker to client regarding how order flow interacts in the marketplace will not only need to be understood by trading teams, but also by those in the back and middle office.

Looking Ahead

Irrespective of the method of execution, dark versus lit, primary versus MTF, European policy makers remain focused on how to create an equivalent USD $850B liquid market. In theory Europe benefits from Time Zone but two thirds of investors continue to invest in US stocks rather than European.

European policy makers may currently be tied up with the energy crisis, moving the Consolidated Tape and the MiFID/R Refit further down the priority list, but the new focus on challenges in the derivatives and commodities market may inadvertently have ramifications on equity market structure evolution. The advantage of increased lit passive liquidity in orderbooks is the ability to maximise potential investor interest in capital markets. With lit public markets at some of the lowest levels, the need to diversify the liquidity pool while maintaining a fair and orderly market remains the core objective. While the Double Volume Cap failed to deliver, new ideas are being discussed on how to improve retail interaction, venue prioritisation and routing of order flow; central counterparty clearing house (CCP) interoperability and cross border trading. Recent events such as the LDI asset switch and the rising sensitivity towards the demand for liquid-assets is only fueling the likelihood of increased systemic liquidity risks. As a result, the market will continue to seek to find new means to innovate which policy makers will inevitably scrutinize closely and adjust regulation accordingly. MiFID Refit delays and recent regulatory pragmatism suspiciously appear as the proverbial lull before the storm.

[1] fca.org.uk/publication/consultation/cp22-18.pdf
[2] esma.europa.eu/sites/default/files/library/esma70-156-4978_consultation_paper_on_the_opinion_on_trading_venue_perimeter.pdf

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