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Market Structure

Liquidity Landscape

2023: What Next for European Markets?

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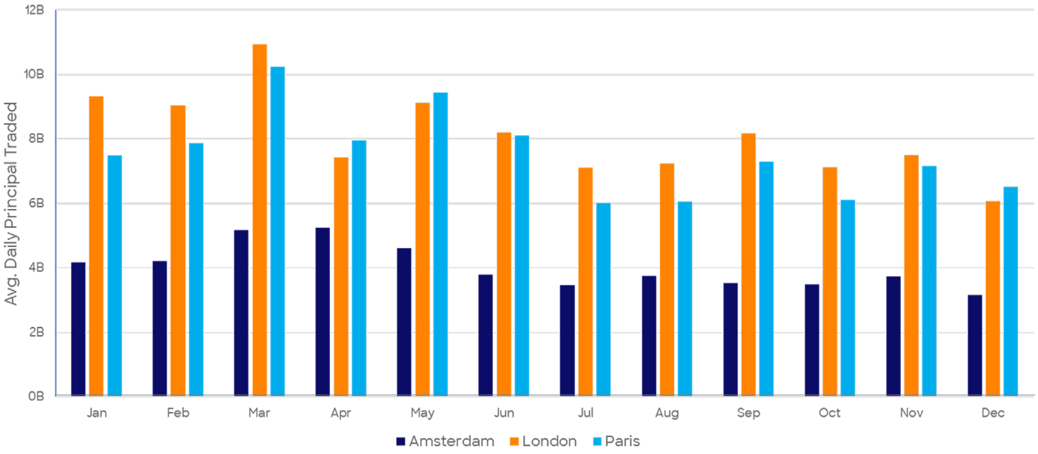
The end of 2022 marked the end of a rocky year for markets, economics, and politics, where we witnessed the wider effects of inflation, events such as the collapse of FTX, to Britain seeing three Prime Ministers in a single year. While a wholesale roll back of regulation in the UK appears off the cards, the ground is still shifting with the UK's intention to shore up its financial sector in the face of growing competition from cities such as Paris and Amsterdam (*Exhibit 1*). Added to which EU Member States have differing approaches to what amendments need to be made, if any to MiFID and MiFIR. 2023 looks anything but straightforward for regulatory policy given the wider headwinds the industry is facing in terms of market liquidity and the impact of the increased use of technology in trading.

Exhibit 1

UK average daily principles traded versus Amsterdam and Paris 2022



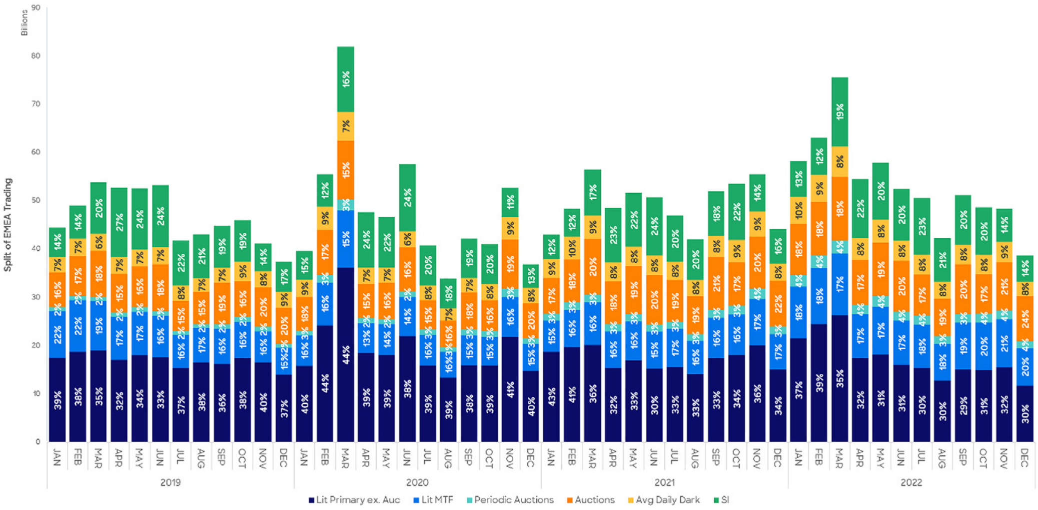
Source: Bloomberg data, January 2022 - December 2022

What we learnt from 2022

Policy makers have acknowledged that MiFID II has failed to deliver in terms of improving continuous lit activity in secondary markets in the European region. This matters to the policy objective of increasing primary listings, thereby potentially restricting European Capital Markets growth and ability to support the transition to a sustainable economy. With European equities market reaching a €53.4B average daily value in 2022 (a 8.2% increase over 2021, see *Exhibit 2*); the question for policy makers is where and what volume traded.

Exhibit 2

EMEA Flow Breakdown



Source: Cboe Market Data and Bloomberg data, January 2019 - December 2022

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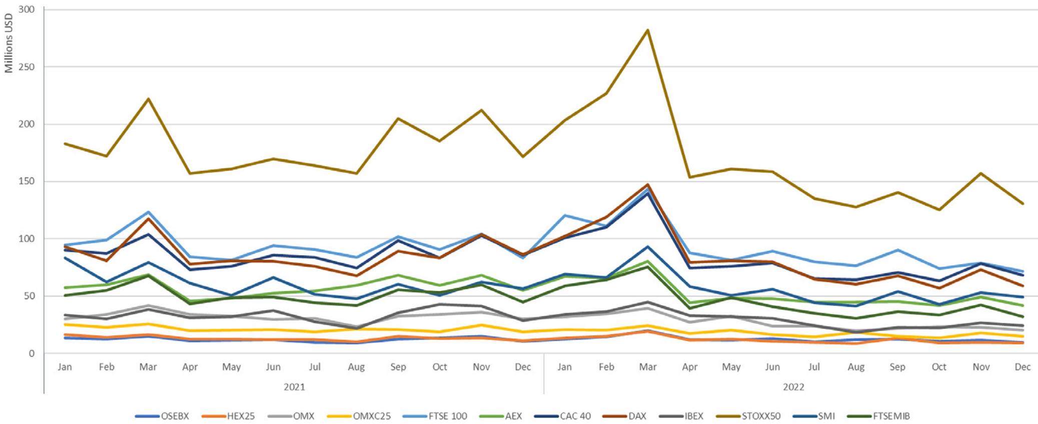
Firstly, liquidity remains centred on the main indexes. Exhibit 3 below shows the turnover seen in a selection of European indexes which has stayed relatively constant bar a spike in the first quarter of 2022.

Exhibit 3

Turnover in EMEA Indexes

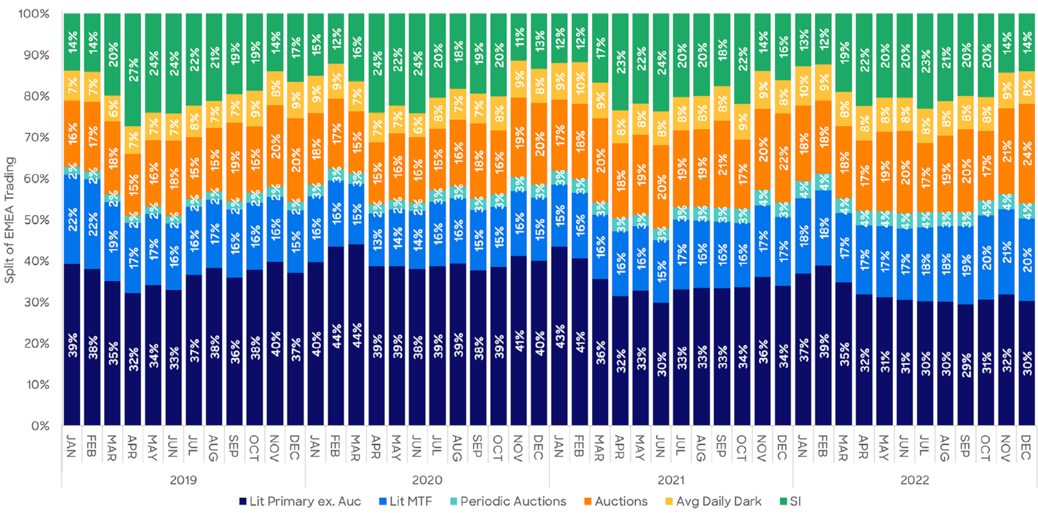


Source: Bloomberg data, January 2021 - December 2022

The second area is how liquidity trades. The proportion of notional traded on Lit primary markets (excluding the auctions) continued to decline, down from ~40% in Q1 2020 to ~30% in Q4 2022. This is in contrast to the proportion being traded in auctions (up ~5% over the same period) and Lit MTFs up by a similar amount (*Exhibit 4*).

Exhibit 4

Anywhere but the Primary



Source: Cboe Market Data and Bloomberg data, January 2019 - December 2022

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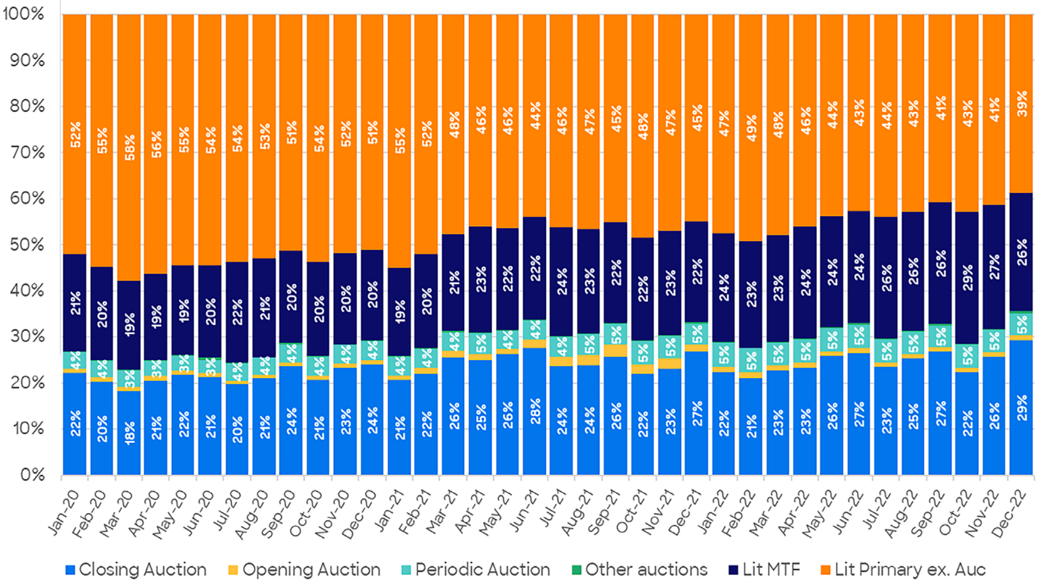
Wider changes in macroeconomics from the war in Ukraine, the post-Covid recovery and rising interest rates have triggered shifts in sector and company valuations leading to large index restructuring. Nearly 30% of order book traded value is now in the closing print (*Exhibit 5*).

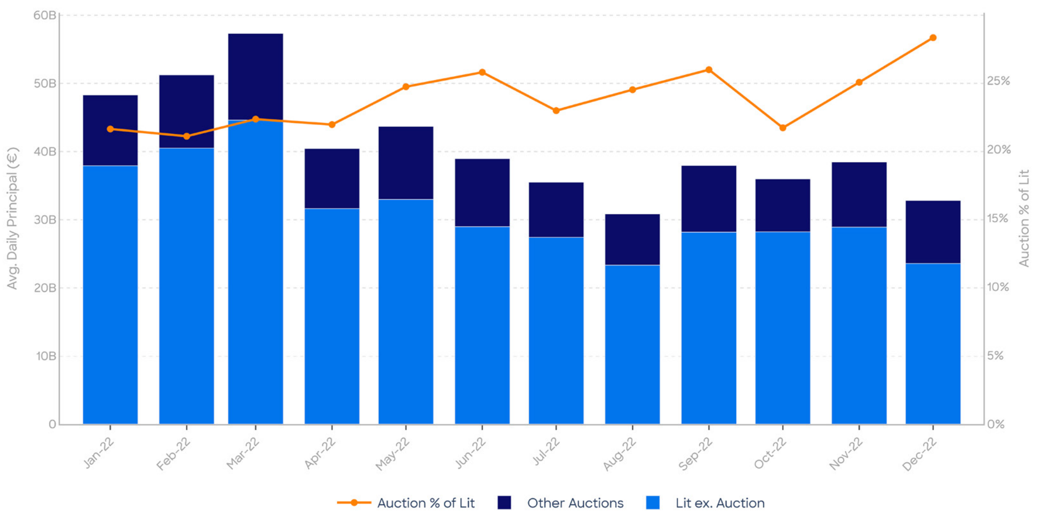
Exhibit 5
Closing Auctions



Source: Cboe Market Data, January 2020 - December 2022

Alongside this, with the percentage of LIT trading made up of auctions, we saw 2022 end on a high and approaching 30% (*Exhibit 6*).

Exhibit 6
Continuous Lit Activity (EMEA)

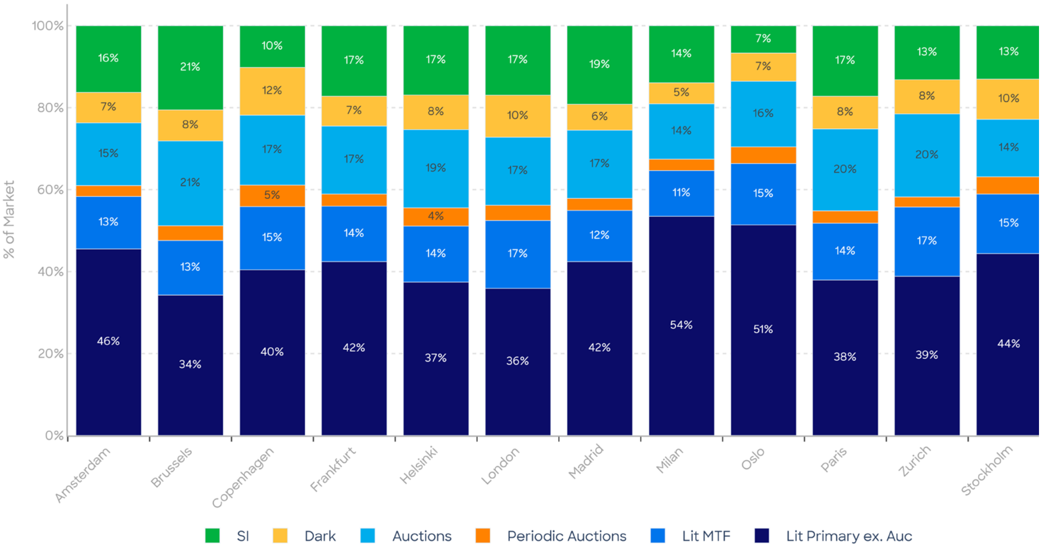


Source: Cboe Market Data, January 2022 - December 2022

Thirdly, there are significant differences between European countries in how transactions occur which hampers the growth of cross border activity. For example, dark trading only accounts for 5% in Italy, but more than 12% in Nasdaq's Danish exchange. With Copenhagen, we also noted a higher percentage of periodic auctions compared to other European venues (*see Exhibit 7*).

Exhibit 7

Breakdown of Execution Flow across Europe

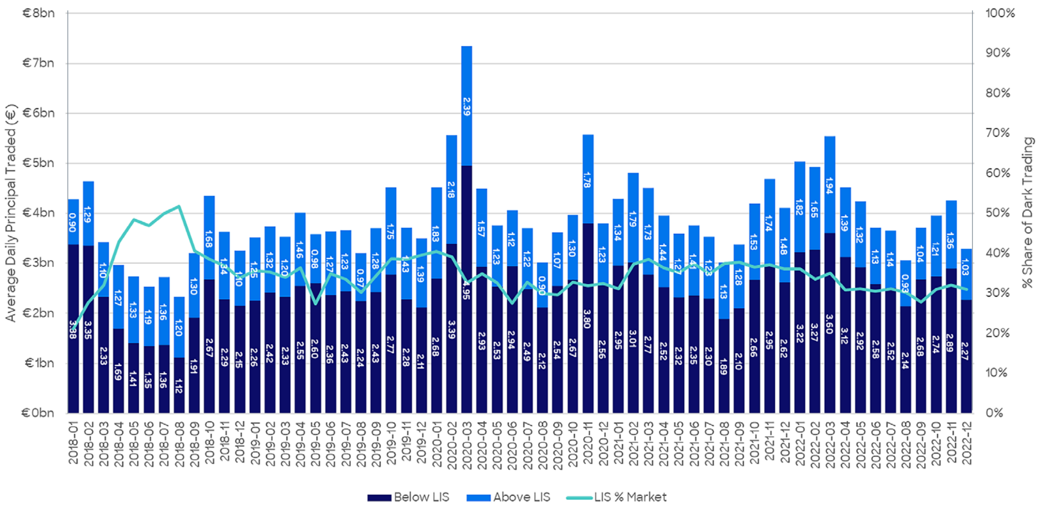


Source: Bloomberg data, January 2022 - December 2022

With the greater fragmentation across European markets and methods of trading, and as continuous liquidity becomes harder to uncover, trading strategies will continue to evolve as a result. On this note, on dark markets and specifically their use of LIS, we saw a decline in both as the dark market and the overall market continues to fall in % terms proportional to the whole market (*Exhibits 8 and 9*).

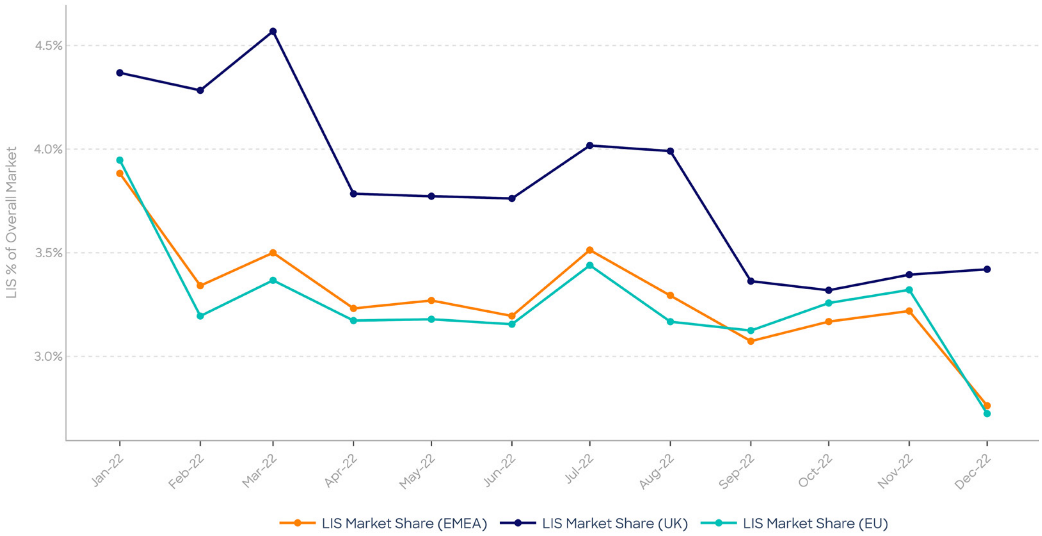
Exhibit 8

Principal Traded in Dark Markets



Source: Cboe Market Data and Bloomberg data, January 2018 - December 2022

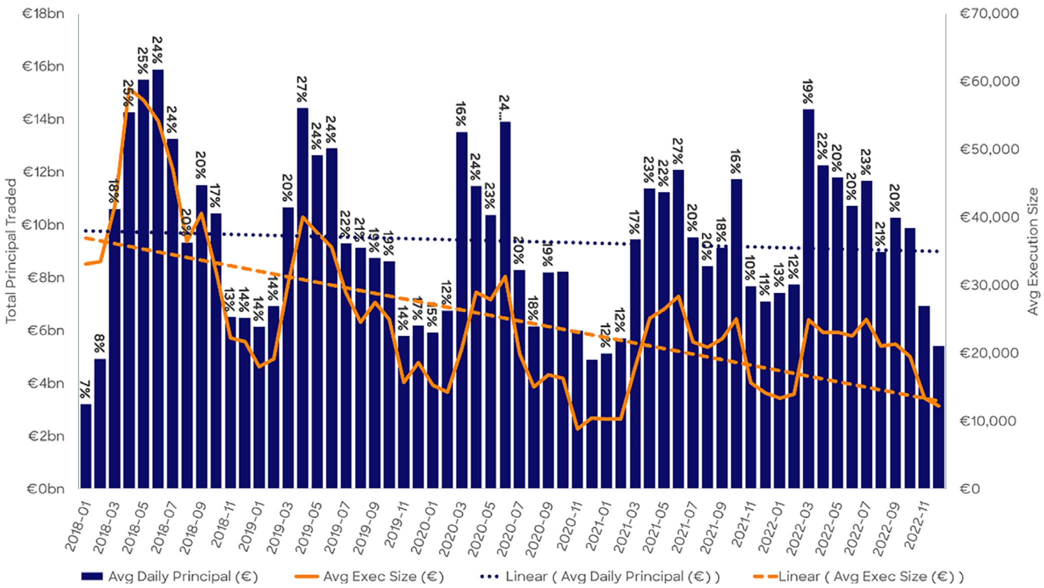
Exhibit 9
LIS as a % of the Overall Market



Source: Bloomberg data, January 2022 - December 2022

SI activity is increasingly trading in smaller clips with the average execution size falling steadily over the past few years. The average daily principal also decreased from >€10B at the start of 2022 to under €5B by the of December (*Exhibit 10*).

Exhibit 10
SI flow



Source: Bloomberg data, January 2018 - December 2022

Historically the argument has been UK trades principal, European trades agency but this appears to no longer be true. The UK in general sees lower average execution sizes alongside a lower average daily principal than the wider EMEA region. However, from our research an interesting note here is that when looking at % of volume executed in SIs (*Exhibit 7*), we see the UK ranking a collective third in SI % executed volume alongside Helsinki, Frankfurt, and Paris.

In summary, we see smaller clips for large caps and a rise in dark trading for small- and mid-caps, the noted decline of the UK250 by 9% (*Exhibit 3*) saw a rise in dark trading from 15.7% to 17.5% of volumes. The more illiquid the stock, the more it trades away from the continuous lit and the need for more integrated and sophisticated trading strategies.

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What next in 2023

Lack of progress in MiFID/R policy objectives and the current impact on liquidity formation is likely to lead to further political influence both in UK and EU to stimulate secondary markets activity. The focus for both regulators is based on a need to enhance data transparency and the harmonization of reporting to bolster confidence in markets. The requirement for mandated data provision in pre-determined formats is likely to lead to greater penalties for non-conformance. In Europe in particular there is a renewed fixation with dark trading and a view that the reason for its persistent existence is the regulatory inability to address dark trading due to the complexity of the Double Volume Cap (DVC).

Further Delays

While the MiFID/MiFIR review is firmly on the agenda, not all member states are on board which could lead to certain provisions in the regulation being postponed. It was notable in the Czech agreement just how much regulatory detail was pushed to ESMA for future deliberations. For example, the ban on PFOF and the deferral regime for non-equities, where the new regime is dependent on a delegated act with Regulatory Technical Standards from ESMA. This means that the current deferral regime will continue to apply until relevant RTS are adopted and a new deferral regime can be implemented. It applies also to the ban on the client order routing practice with a possibility for Member States to assess "discretionary" use. The MiFID/R review is a long way from being completed.

New Challenges

Also, current regulatory proposals fail to address wider concerns – yet. The underlying focus is shifting from the sell-side post GFC 2008 to the inherent liquidity risks within asset management. The full life-cycle of trading is increasingly in the regulatory limelight with the European settlement discipline of a redacted CSDR but perhaps more importantly, the move to T+1 by the US and Canada. Investments are held globally and while the majority of trades settle successfully, lack of investment in automated processes and infrastructure in the back office will exacerbate a strained system. With the majority of cash management cycles at T3 or even T4 but trading at T1, there is a growing mismatch between cash and asset flows at a time of tightening margins and rising interest rates, and options for fund managers are shrinking. Not all funds have mandates permitting use of derivatives as an interim measure to gain performance exposure. Operating an overdraft on the fund to manage this mismatch is less appealing from both a regulatory and an economic perspective.

Any additional management and set up costs are an unnecessary burden to an already pressured European fund industry – which in turn is leading to greater investment in technology – which is also firmly in the regulatory headlights. While the Trading Venue Perimeter is in the MiFID/R proposals, agreement has not yet been reached on just how to regulate the sector. ESMA are also focusing on the requirement to investigate industry comprehension of electronic trading and the rising use of algorithms, including auto generation and routing of orders (Art 17 of MiFID and RTS 6).

ESMA's five-year strategy focuses on fostering deeper and more effective capital markets to create greater financial stability; to strengthen single supervision of EU financial markets to better protect investors.[1] This includes ESMAs role as a data and information hub which means closer scrutiny on the different ways in which AI and Machine Learning are now used in trading, risk management, and the robustness of market resiliency from market manipulation.

What Are the Proposals for MiFID/R[2]

A Consolidated Tape – Finally

A key area for the improvement of data is outlined in the Czech Proposals for the delivery of a Consolidated Tape – real time pre- and post-trade, noting the need to address the three core reasons why a provider (CTP) has failed to emerge:

- Lack of clarity around how CTP can procure data
- Insufficient quality in data harmonization
- Lack of commercial incentives

[1] https://www.esma.europa.eu/press-news/esma-news/esma-announces-strategic-priorities-next-five-years
[2] https://data.consilium.europa.eu/doc/document/ST-16098-2022-INIT/en/pdf

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ESMA has been mandated to deliver a Bond Tape first, but the European regulator is instructed to start the selection procedure for shares and ETFs within six months. ESMA is also instructed to determine the detail regarding the mandatory contributions of "core" market data from all market data contributors (including SI, APAs, and CTPs). Contributors will need to use harmonized templates to ensure data quality standards can be improved, and to provide the data as close as technically possible to real-time using synchronized timestamps.

Pre-trade data must be provided by APAs and trading venues operating a CLOB or FBA and include best bid offer spread. Whereas **SI and venues using RFQ** or other trading protocols would provide **post-trade** data only.

The data quality requirements are to be specified by the European Commission in a Delegated Act based on advice of a dedicated consultative group led by ESMA.

Level Playing Field

There is a perceived belief that "On Venue" trading activity ensures all participants can compete on equal terms (price, size, and time). This ignores the basic premise that trading can never be equal; options to trade 100 shares of Vodafone will always be greater than attempting to trade an illiquid Nigerian bond. Even when looking at on venue activity – the difference between trading in a continuous lit market provides lower levels of protection than when trading in the dark (on an MTF) or using a frequent batch auction.

To address the perceived imbalance, the Czech Presidency have proposed moving Article 1(7) of Directive 2014/65/EU to Directive 2014/65/EU to Regulation (EU) No 600/2014. The ruling that **hybrid systems can only perform multilateral trading activities where they are licensed as a regulated market, a multilateral trading facility ('MTF') or an organised trading facility ('OTF') will be law, alongside the definition of 'multilateral system' as "any system or facility in which multiple third-party buying and selling trading interest in financial instruments are able to interact in the system."**[3] The exact definition of what "multilateral" means is still the subject of regulatory debate but further guidance is due from ESMA at the end of January, and from the FCA early Q2, which could have a significant impact on how firms are able to engage with technology providers, even forcing them to become registered MTFs.

This matters as a large proportion of activity still takes place "Off Book" – trades negotiated 'bilaterally' between a broker or market maker and their client, either electronically or manually. Under the Czech Proposals, Sis have retained the ability to match at mid-point for all trades, but ESMA will need to reassess every two years. Trading off venue is also permitted under the use of waivers. However, the exemption for trades in shares which are non-systematic, ad-hoc or irregular and infrequent has now been removed.

Improve Regulation of Equity trading

The Czech Presidency also addressed the concerns regarding the continued perception of high levels of dark trading in Europe. Removing the complexity of the Double Volume Cap to a Single Volume Cap (SVC) of 10% makes sense, whether this leads to an ability to enforce and ultimately move more dark activity back onto the lit remains to be seen. There was also greater clarity on the Share Trading Obligation (STO) which will only extend to shares with an EEA ISIN admitted to trading on a regulated market or trading venue.

Ban on PFOF

Regulation (EU) No 600/2014 will be amended to introduce a new Article 39a covering a **direct ban of the practice of receiving fees or commissions or non-monetary benefits from any third party for forwarding clients orders to any third party for execution** to generally enhance harmonization of rules in the Union.[4] However, there is a wide caveat leaving question marks as to whether there is actually a PFOF ban or not!

[3] Article 4(19) MiFID II
[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021PC0727

Improvement to Non-Equity Transparency

The Liquidity Landscape covers equities only, however it remains important to keep an eye on what is happening in the fixed income space, as policy decisions here can have ramifications elsewhere - policy decisions on the Trading Venue Perimeter being a case in point.

Here policy makers are looking to simplify and streamline reporting obligations. As such, the requirement to publish firm or indicative quotes pre-trade for RFQ and SI should be removed. Quotes are tailored to individual clients, so they have marginal informational value to other clients. For post-trade – data on price and volume is to be published as close to real time as possible. Any deferrals are to be harmonized by ESMA, and again here, this requires a delegated act and Regulatory Technical Standards from ESMA, which means the current deferral regime will continue to apply for the foreseeable.

On derivatives, the Czech Proposals cover the introduction of an entirely new transparency regime to the current TOTV, limiting pre-trade transparency to only the most liquid ETD and just a subset of benchmark OTC derivatives, denominated in G4 currencies, centrally cleared and in full year tenors.

Looking at the Bigger Picture

It is clear that the proposals will have unintended consequences from a greater reporting burden which could impact survival of smaller brokers, but industry work on standardized formatting protocols such as MMT should alleviate some of the industry's concerns. What is of more interest in what has not yet be covered in the MiFID/MiFIR review but is the focus on regulatory scrutiny in the US – namely the reduction to T1 settlement, rebundling of research payments through allowing the SIFMA no-action letter to expire[5] and greater transparency on best execution.

While European asset managers are unlikely to see a reduction in settlement post CSDR, there are significant implications in getting the money to work from the lack of US broker trade confirms on trade date to the need for local staff to operate in the same time zone to ensure matching on T to meet overnight batch runs. Interestingly the main issue may not be the move to T1 from T2 but rather the mismatch between cash and market timelines which are already causing challenges in terms of managing fund overdrafts as margins are increasingly constrained.

While the SEC is doubling down on Best Ex proposals, the Czech agreement is suspending the production of reports under Article 27(3) of Directive 2014/65/EU for the next two years in order to review what information should be provided. Feedback from stakeholders has shown that current Best Ex reports are rarely read and do not enable any consumers or investors to make meaningful comparisons based on the information provided. Interestingly the document references the emergence of a consolidated tape post-trade information may be useful for documenting best execution.

What Will Happen When

The Swedish Presidency of the European Council runs until June of this year, with the main body of work focusing on a joint common position between the Council and Parliament. This then needs to be approved by the Commission before moving the MiFID/R Reform into the Official Journal by the end of Q2. In July, the Presidency moves to Spain which given the EU Parliamentary elections in 2024, member states will be focusing on campaigning for re-election rather than reviewing MiFID.

Regulatory policy for financial markets whether in Europe, the UK, or the US is set to continue meaning the industry will need to continue to stay abreast of the implications for trading. With trading volumes unlikely to return to the continuous lit but morph into the means of liquidity creation – predefined market participant roles will continue to evolve. Asset managers will still require the back-stop of trusted execution partners – but who they trade and the technological services they need to engage with the increasingly fragmented liquidity is set for further evolution.

[5] https://www.sec.gov/investment/sifma-110419

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