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EUROPE'S LIQUIDITY CRISIS: WHY KNOWLEDGE IS POWER FOR BUY-SIDE PARTICIPANTS

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Whatever the intentions of European regulators when they began their post-crisis regulatory overhaul, there appears to be little question that it has ushered in an environment where liquidity has become increasingly hard to find. Investment banks are internalising their flows more than ever, intraday lit trading activity has suffered steep declines, and the amount of non-addressable liquidity has only climbed. What does this mean for buy-side participants who are under pressure to get best execution in such an opaque marketplace?

In this Financial Markets insights report, we hear from two of the world's largest buy-side companies as well as a leading sell-side group. We learn about what's causing the current crisis in liquidity, and, more importantly, what initial steps investment firms can take to deal with it. Given the complexity of the situation, it is clear there are no simple solutions. But by focusing on a dialogue with their sell-side providers, buy-side participants can at least position themselves to take better advantage of fast-evolving market dynamics. As with so many things, it seems that knowledge is key.

The report features **Simon Steward** of **Capital Group**, **Evan Canwell** of **T. Rowe Price** and **James Baugh** at **TD Cowen**, which is now under the umbrella of The Toronto Dominion Bank. Steward is head of EMEA equity trading at Capital Group, the global investment manager that manages more than $2.3 trillion. Canwell is an equity trader and market structure analyst at a company that has been investing for more than 85 years and looks after more than $1.6 trillion in assets. And Baugh is head of market structure for EMEA at one of the world's leading trading service providers. Apart from their deep levels of market knowledge, these three share something else in common: the experience of grappling with a liquidity-strapped marketplace.

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UNINTENDED CONSEQUENCES

It's been five years since MiFID II came into force. Regulators were clear from the outset that they wanted to support investors, setting out a raft of measures designed to increase market transparency and discourage sell-side practices that might result in firms not always getting the best execution they might have received.

But the result has not been what regulators – or indeed many in the market – might have expected. As sell-side firms, exchanges and other trading venues have had to adapt, they have adopted new practices that have caused less liquidity and less market transparency, not more.

For instance, from 2018 to 2021, the amount of lit continuous trading activity averaged between 50% and 60%, according to a report by Liquidnet. But by the end of the first half of this year, that share had fallen to close to 40%, with record-low levels of lit continuous trading activity.

It's not just lit activity that matters here. Increasing amounts of liquidity that are sloshing about in the market are being classified as non-addressable. That means that bid and offer prices are not being posted in venues or on mechanisms where investors at large can see or act on them.

Since MiFID II, there has been a near 20% increase in overall trading activity reported to the market as non-addressable in nature, including over the counter (OTC), off-book on exchange negotiated trades (NT) and off-book Systematic Internaliser (SI) business.

For the buy-side, these developments have created an urgent need to understand a wide range of issues, from how market structure has evolved to the implications of new regulatory measures to clarity about what venues and sell-side participants are doing in response.

"It has never been more important to fully understand how our partners access liquidity," says **Evan Canwell** of **T. Rowe Price**.

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Evan Canwell, T. Rowe Price

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INTERNAL AFFAIRS

The increase in SI business is a major factor and is easily explained. As the costs of doing business have risen and margins have shrunk, sell-side firms have been under pressure to limit their own costs. One result of this has been the development of SIs, where sell-side participants have internalised as much of their flow as possible.

"Internalisation is a major, if not the, driver of these changes in liquidity," says **Simon Steward** of **Capital Group**.

"The sell side is having to be more focused on cost considerations in terms of execution decisions as margins are increasingly challenged. However, maintaining the best outcome for our clients remains our key objective and our aim is to make sure that cost considerations do not inhibit this.''

T. Rowe Price's Canwell in fact suggested his firm keeps a close eye on the amount of its business that interacts with internalisers. "Only around 5% of our overall fills come from electronic liquidity providers or broker SI activity. While this inherently comes with less market transparency, given the nature of the business, we depend on these detailed conversations to determine our comfort level with interactions under the SI regime," Canwell said.

But increasing their SI activity is not all that sell-side firms have done. They have also boosted their off-exchange activity, creating alternative mechanisms and offering more bilateral liquidity provision. Some of this was prompted by the regulation. For instance, the new regime removed broker crossing networks (BCNs), which had previously operated as internal liquidity pools within banks and brokers.

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Simon Steward, Capital Group

At the same time, the response by market participants has led to new liquidity patterns. Closing auctions have become increasingly significant and this has potential effects both on price formation during these periods and on what happens during the rest of the day. In addition, some of the closing auction activity is taking place off of primary exchanges, where liquidity may not always be addressable.

Reports from exchanges as well as academic studies have shown a marked rise in the amount of activity at closing auctions. These auctions typically mean less fragmentation as market participants all take part during a concentrated time period, but it can have a distorting effect. One study by the French market authority showed that the share of daily trading activity that occurred during the closing period ballooned from 20-28% in 2015 to 41% by 2019.

A broader study by Blackrock found the average amount of activity over a similar period doubling to 26% from 13% across a wide variety of venues. Regulators have worried that this concentration risked undermining the price formation process.

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CROSS-CHANNEL COMPLEXITIES

All of this has forced buy-side firms to think long and hard about their liquidity strategies, and crucially, to make sure they have the requisite knowledge and skills needed to get best execution.

The conversations that Canwell's firm has with its sell-side provers cover the full spectrum of liquidity-related issues, not just SIs. "We spend a lot of time engaging in detailed conversations with our brokers and liquidity counterparts," he says.

Canwell also noted that Brexit had added a layer of complexity to the task of focusing on liquidity. For instance, there has been a divergence of approaches in terms of dark trading between EU markets and the UK. At the same time, the UK has recently announced its own post-Brexit rules in response to the Share Trading Obligation (STO) under the Markets in Financial Instruments Regulation (MiFIR). The STO required that any EU trading firm interact only with venues considered as equivalent in terms of their regulatory framework. Meanwhile, the UK's market regulator, which previously has warned of the dangers of an uncoordinated approach, is taking a more flexible approach than the EU.

The flow of liquidity inevitably will be affected by having different regulatory regimes for continental Europe and the UK. But understanding exactly how may take time.

There are numerous aspects to the rules, large and small, that will need to be rolled out and digested by the market before the full implications can be understood. For instance, MiFIR includes a provision called the Double Volume Cap, or DVC, which is aimed at limiting the amount of dark trading on venues. The UK, meanwhile, has said it will let venues use waivers that could allow trading to take place without pre-trade transparency.

At the same time, the health of the UK market is inextricably bound up in what is happening elsewhere in Europe.

"As much as we strive to address the transparency and fragmentation concerns in the trading landscape, it is evident that tackling the overall growth and value proposition of EU capital markets ultimately holds the key to unlocking future liquidity," **James Baugh** of **TD Cowen** says.

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UPPING THE GAME

Sell-side firms need to be ready to work with the buy-side, not just to offer them services, according to Baugh. That goes not only for discussions about electronic trade but also high-touch activity.

"We are very much in this ecosystem together," Baugh says. "Forming partnerships and working closely with clients to gain a better understanding of market structure and liquidity challenges has never been more important. These collaborations and conversations extend beyond electronic and low-touch channels, encompassing high-touch and multi-asset engagement."

As sell-side firms face a larger and more complex set of rules for how they conduct business, buy-side firms have given more ability to determine their own paths. But that places a greater onus on investment firms to understand and focus on liquidity factors. In the past, much of that would be taken for granted as part of the responsibility of their sell-side providers.

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Capital Group's Steward says this shift has led to his company requiring greater transparency in its relationship with liquidity providers. That in turn has led them to continually consider both its workflow and the evolving skillsets of its trading team. He said his firm has a much better understanding of costs, both in terms of brokerages and venues, in terms of the liquidity interactions of its brokers.

"We ask a lot of questions and have high expectations from both our high-touch and low-touch connections," Steward says. "We are upskilling our desk by providing greater context around execution quality which in turn is helping refine our processes, this also seems to be the broader street approach. Our ability to receive digestible and informative advice around market structure and liquidity dynamics is now absolutely crucial to our workflow."

The new way of working represents a clear break from the past.

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"In previous market cycles, where fragmentation and liquidity concerns were absent to a degree or perhaps caused less of a concern, there wasn't as much time and focus spent on educating internal stakeholders on areas such as pre-trade transparency and liquidity profiles," Steward said.

But provided a firm invests in transaction cost analysis (TCA) and its own understanding of the liquidity landscape, it may be able to take a more relaxed view about issues such as the amount of trade conducted via internalisers.

"We remain agnostic regarding liquidity providers," says Steward. "We rely on our robust transaction cost analysis (TCA) processes to assess and help identify anomalies in order to prompt the right questions. Our due diligence is vital based on the requirements for a broad-spectrum of liquidity given our diverse range of order flow."

Canwell said T. Rowe Price's focus on TCA meant it could discern what its liquidity providers were doing via each firm's algorithms.

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In a world where liquidity is not commoditised, it therefore pays to invest in this kind of knowledge.

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TRUST AND TEAMWORK

Markets may be a cut-throat business, but ultimately, they depend on relationships that can endure. For the large buy-side firms – such as T. Rowe Price and Capital Group – those relationships are often multi-layered and multi-faceted.

Canwell said T. Rowe Price saw its relationship with the sell side as both long term and reciprocal. "The trust we've built spans across multiple areas of the firm and while market structure and liquidity provision evolve, the importance of old-fashioned etiquette remains," he said.

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Provided that kind of trust can be developed, the benefits for all parties can be significant. "It fosters important conversations and the opportunity to share insights on market dynamics with clients, which may otherwise be missed," says Baugh.

Whether an investment firm wants to understand how it should navigate closing auctions, how much flow it should allow with systematic internalisers, what it should do regarding differing regulatory regimes, or any of the other issues thrown up in today's marketplace, it is clear that the buy-side will benefit from deepening and intensifying its dialogue with the sell side.

Without a doubt, the need to be thoughtful about what, where and when to interact with liquidity is more important than ever. For buy-side firms, this puts extra weight on the question of who to partner with.

Will their providers understand these crucial requirements and be able to manage interactions with liquidity partners to help them achieve the best outcomes? If they can get some level of assurance on that front, the challenges we've talked about here may turn out far less onerous.

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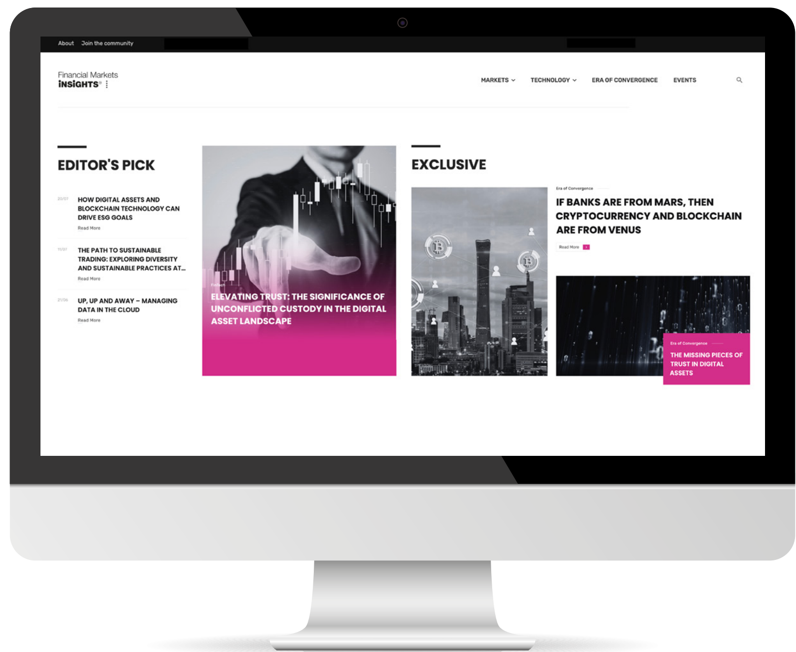

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