Why we shouldn't be too miffed with MiFID II

While the financial reforms pose risks to trading, we can take heart from the benefits of greater transparency, says Ed Wicks, Head of Trading at LGIM.

Ed Wicks leads LGIM's Global Trading team. The team is at the forefront of LGIM's efforts to create better outcomes for our clients through best execution.

The introduction of MiFID II has been something of a headache for many market participants, to say the least. But just as some potential problems stemming from the regulatory overhaul are becoming increasingly clear, so too are its possible benefits.

We certainly have concerns, in particular regarding the so-called double volume caps (DVCs) on equity trading in dark pools – private venues run by banks, exchanges and independent operators where deal information is published only once trades are completed.

These caps impose limits of 4% to each dark pool for total trading in an individual security over a rolling 12-month period, and 8% of overall volume for the trading of a security across all such venues. Dealing in a security will be banned for the next six months in the event of a breach of these caps, either from the pool where the cap was breached, or from all dark pools.

On 7 March, the European Securities and Markets Authority (ESMA), the supervisory body behind the regulation, published its first DVC calculations, which led to limits being imposed on the dark trading of hundreds of instruments.

FRAGMENTING MARKETS

In our view, the levels at which the caps have been set are somewhat arbitrary and risk creating further fragmentation in capital markets, a loss of liquidity and a rise in transaction costs. Despite the regulators' efforts to drive market participants towards 'lit' exchanges, where there is pre-trade transparency, we believe people are likely to seek out cheaper ways to transact elsewhere.

There is a solution, however, for trades that are designated 'large in scale' compared with normal market size: here, waivers can be applied to the caps, meaning this type of activity will not be restricted by the DVCs. Given our scale, many of our trades are likely to meet this definition – but not all.

We will monitor the impact of the DVCs to ascertain whether transaction costs rise. If they do, we will share our findings with the Investment Association, the Financial Conduct Authority, and ultimately ESMA, to highlight our concerns.

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BANNING BCNS

Another important change under MiFID II for equities trading relates to the disappearance of broker crossing networks (BCNs), structures used by brokers to cross client orders, thereby facilitating transactions without having to pay exchange fees.

When we previously transacted via BCNs, we did not know exactly which institution was on the other side of our trade, although the broker would inform us of their broad category; for example, asset manager or hedge fund. Now BCNs have been banned in Europe, a lot of this volume has begun to migrate to other venues, such as systematic internalisers (SIs).

These allow brokers and electronic liquidity providers to match or internalise client flows against their own capital.

Similar to BCNs, SIs offer the potential for price improvement. However, unlike BCNs, they offer greater transparency and more controlled access to market-makers. Since SIs transact in a principal capacity, whereby they buy or sell for their own account and at their own risk, it is crucial to understand over what period they recycle their risk; i.e. for how long do they hold positions on average?

Only by understanding the various risk models is it possible to determine whether a particular SI is an appropriate venue in terms of best execution.

A NEW ERA FOR FIXED INCOME

The impact of MiFID II on fixed income trading appears just as mixed as it is for trading in equities; however, there are elements we find encouraging.

Here, too, the changes centre on transparency, a key theme in the regulation across all asset classes. In particular, the requirement for greater post-trade transparency – coupled with the derivative trading obligation, which moved over-the-counter trading in liquid derivatives onto organised venues – has had a profound effect on workflows in fixed income markets.

Much activity has now been driven onto electronic trading platforms like TradeWeb and MarketAxess; by trading via these so-called multilateral trading facilities, firms are able to satisfy their post-trade transparency obligations. We believe this is a positive development.

Obliging traders to confirm their transactions electronically has led to a reduction in operational risk. In addition, 'electronification' of the trading process has allowed for greater efficiency and the capture of more granular trading data. This not only enables greater analysis of transaction costs, but it also allows traders to innovate by developing and using new trading protocols.

As the benefits of electronic trading become more apparent, fixed income traders may favour automating some of their small trade flows, freeing them up to concentrate on the larger, more complex orders.

While significant work on technology and connectivity was necessary in order to be able to send certain securities to platforms, now this has been completed, we can enjoy the benefits.

The new regulations form a huge, multi-faceted endeavour of which the areas we have highlighted are but a small piece. Even as we remain keenly aware of the risks it poses, we take heart from its positive effects. We will continue to work closely with regulators and industry bodies to help shape the regulatory landscape for the benefit of all market participants.

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