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The Impact of MiFID II on Equity Trading

GREENWICH ASSOCIATES

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ANTICIPATING THE START OF MIFID II, TRADING DESKS ARE BEGINNING TO TRANSFORM THEIR PROCESSES AND WORKFLOWS

67%

OF EUROPEAN BUY-SIDE TRADERS EXPECT TO INCREASE THEIR USAGE OF TCA NEXT YEAR

Executive Summary

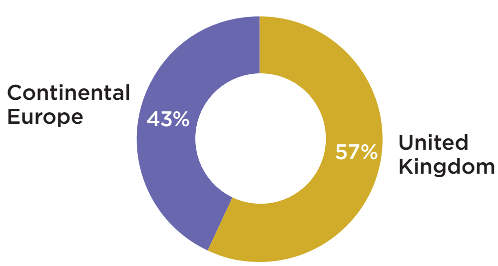
The Markets in Financial Instruments Directives II (MiFID II) is scheduled to go into effect in January 2018. Much of the discussion and debate so far has focused on the new requirements mandating the separation of research payments from trading commissions (unbundling). This will undoubtedly have a profound effect on the market for investment research. Receiving far less focus, however, is the other half of the unbundling equation—how related changes in trading services will impact the market.

With research fully unbundled from trading, asset managers will select their trading counterparties based solely on their trading prowess: execution performance, liquidity sourcing, algorithmic products, and overall service. MiFID II regulations also include new rules specifically addressing trading—including new pre- and post-trade requirements and regulations around dark pool caps and trading venues. Taken together, these new regulations have the potential to transform the trading landscape in Europe and beyond.

METHODOLOGY

From March to April 2017, Greenwich Associates interviewed 55 buy-side traders and head traders based in Europe about expected changes to their trading workflow following the implementation of the MiFID II regulations in 2018.

RESPONDENTS BY REGION



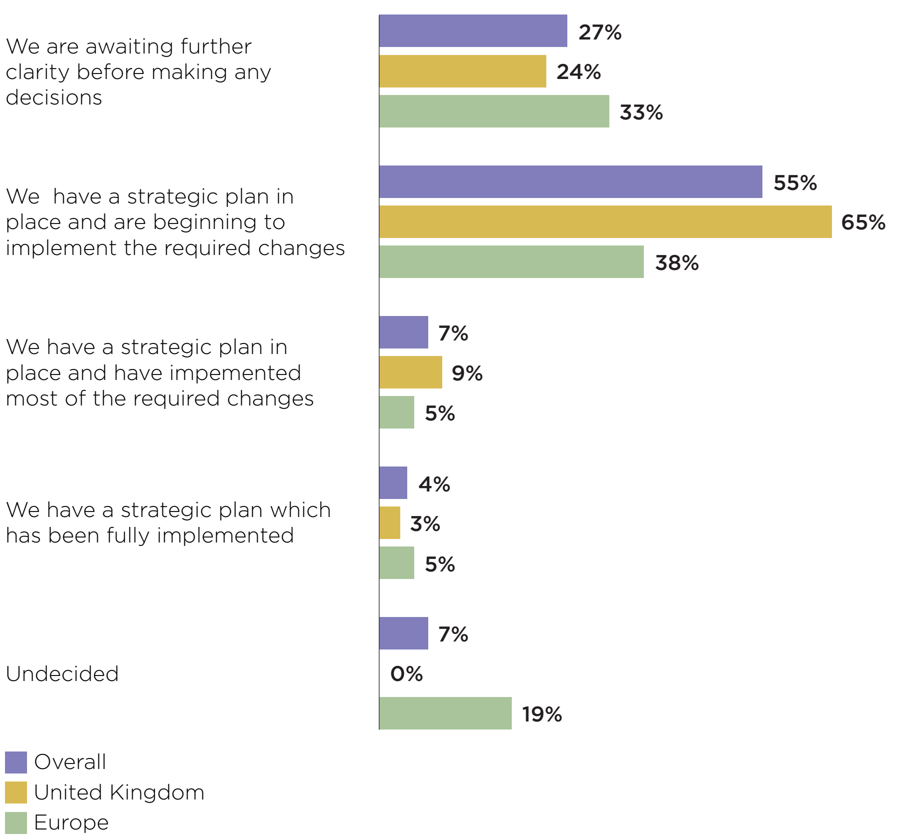
Note: Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Buy Side Prepares for Changes to Trading Workflow

With the implementation date for MiFID II just eight months away at the time of sampling, our data shows that two-thirds of traders have drawn up a strategic plan identifying the changes they will need to make to the trading process in order to best comply with MiFID II. Only 11% of buy-side traders have applied most or all of the trading workflow changes that they deem necessary. A majority, 55%, are currently working through this strategic plan.

When analyzing this data based on the location of the respondent, however, we see some significant differences in the level of preparedness between U.K.-based respondents and those in continental Europe. Over 50% of continental Europe-based traders are either undecided on what changes they need to make or are awaiting further clarity. This suggests there will be a significant rush to comply and make changes in the second half of 2017.

LEVEL OF PREPAREDNESS

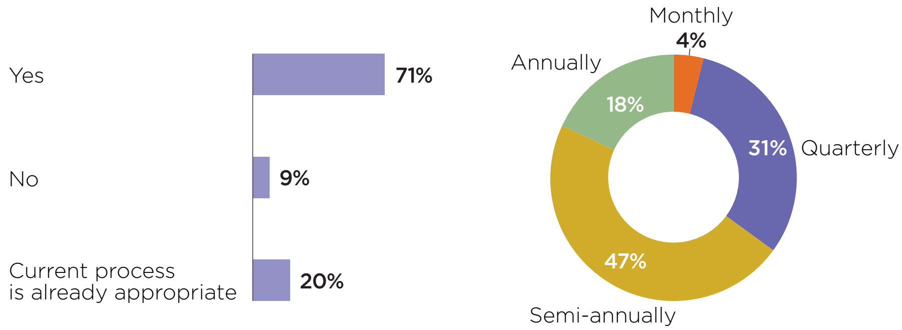


Note: Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Many European asset managers are revamping their research evaluation process in light of MiFID II, and most are also planning to make changes to the way they assess their execution brokers. Most anticipate conducting a review twice per year.

BROKER REVIEW PROCESS

Planning Changes to Review Process — Frequency of Review



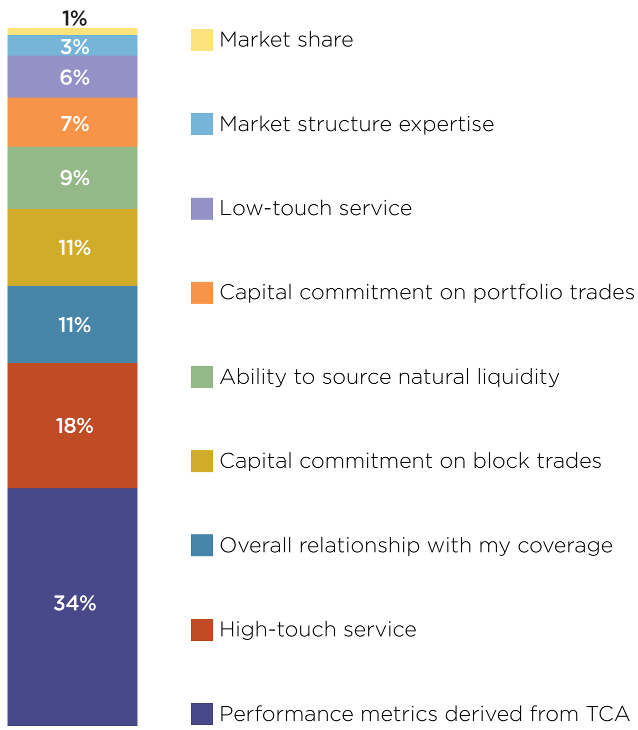
Note: Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

TCA and Relationships Will Drive Execution Review

As of January 3, 2018, all trading desks will have full discretion over where to route orders without regard to research commitments. As illustrated in the following chart, desks will consider a number of factors, but execution performance (i.e., metrics derived from TCA) receives the greatest weighting. Service on high-touch trading and the overall relationship are the next two most important factors, and in conjunction with low-touch service, comprise about a third of the weighting in evaluating execution brokers. Traders should take heart that despite these significant new regulations, trading is expected to remain a relationship business after MiFID II.

MiFID II regulations will mandate a higher standard for best execution requirements. Under MiFID I, investment firms were required to take “all reasonable steps” to achieve the best possible result for their clients. Under the new regime, this wording has been beefed up to require firms take “all sufficient steps” to ensure the best possible execution for clients. Factors that need to be considered include: price, costs, speed, likelihood of execution and settlement, size, nature, and any other factor relevant to execution.

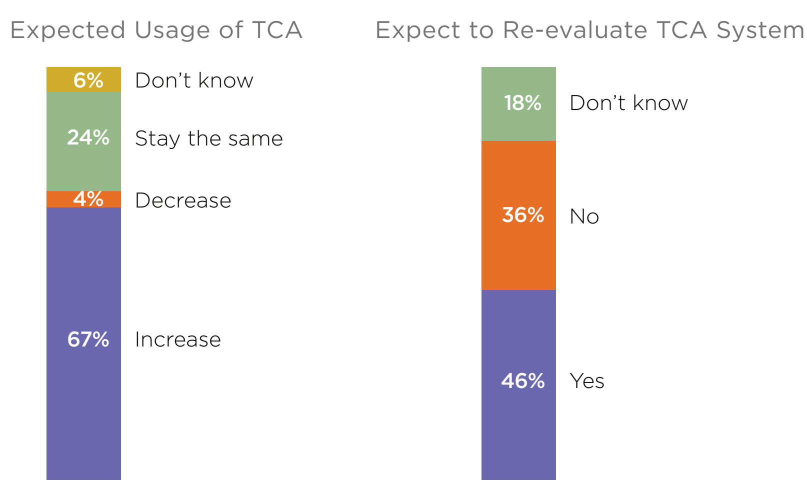
WEIGHTING OF FACTORS IN BROKER EVALUATION



Note: Based on 54 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Given the heavy weighting that TCA metrics will play in the execution broker review process and the more stringent regulatory obligations, it is not surprising that over two-thirds of European buy-side traders expect to increase their usage of TCA next year. Indeed, almost half expect to review their TCA system to ensure they have the best tools to allow them to comply with the new MiFID II guidelines on TCA.

TCA USAGE

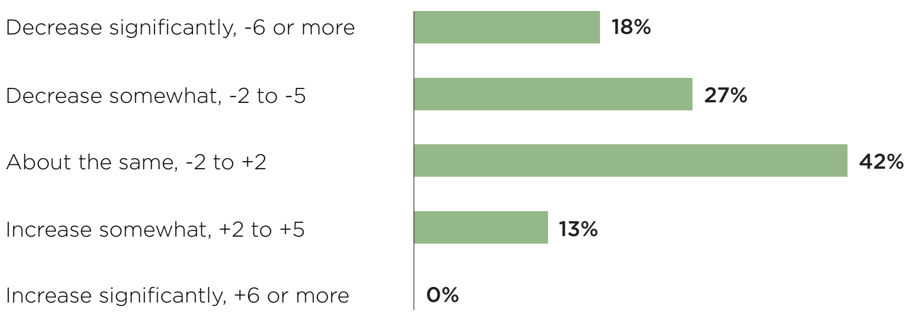


Note: May not total 100% due to rounding. Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Broker Lists Will Shrink and Evolve

The revamped broker evaluation process in Europe appears likely to create some fallout in broker lists. Eighteen percent of traders expect to reduce their broker list significantly—by 6 or more brokers—and another 27% expect a more modest decrease. Only 13% expect an increase in the number of executing brokers used. Taken in aggregate, these numbers translate to an overall reduction of just under two brokers.

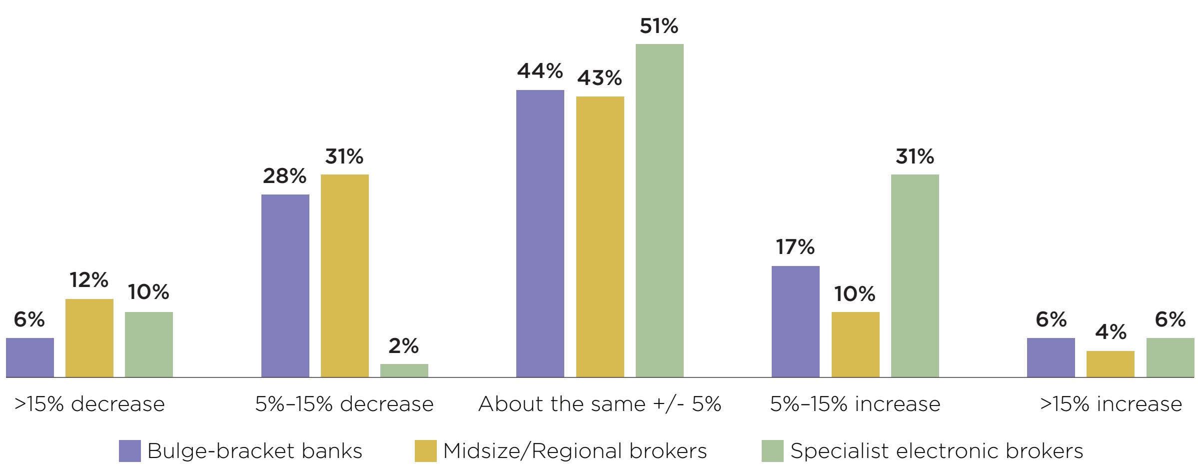
EXPECTED CHANGE IN QUANTITY OF EXECUTING BROKERS



Note: Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Despite the net reduction in broker lists, specialist electronic brokers are expected to see an increased level of business. Thirty-seven percent of traders plan to route more flow to these brokers, versus 12% who expect to route less flow. These gains will come largely at the expense of midsize/regional brokers, although bulge-bracket brokers are also likely to see a reduction in flow.

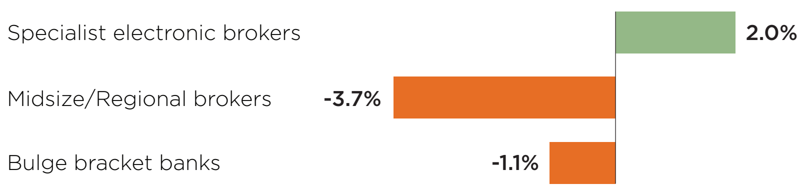
CHANGES IN USAGE OF EXECUTING BROKERS



Note: Based on 54 responses for bulge bracket banks, 51 for midsize/regional brokers and 49 for specialist electronic brokers.
Source: Greenwich Associates 2017 MiFID II European Trading Study

These dynamics reflect the nature of the unbundling regulations. Specialist electronic brokers are already unbundled and completely focused on execution, whereas midsize and regional brokers have traditionally relied on their research expertise to win trading business. In addition, many specialist electronic brokers have or are developing products to service other functions that will be crucial post-MiFID II, including broker evaluations, commission management and research payments.

EXPECTED NET CHANGE IN FLOW



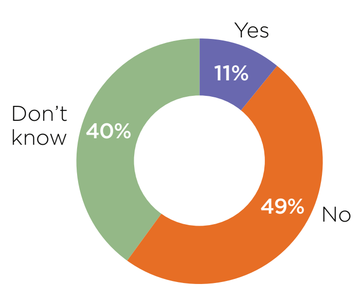
Note: Based on 54 responses for bulge bracket banks, 51 for midsize/regional brokers, and 49 for specialist electronic brokers.
Source: Greenwich Associates 2017 MiFID II European Trading Study

In a bundled, pre-MiFID II world, a trading desk was seen as an essential mechanism for research brokers to receive payment. Many midsize/regional brokers have expertise in high-touch trading and in sourcing liquidity in the names their research department focuses on. However, they often lack the resources to build and maintain a high-performing, low-latency, electronic execution suite. The solution for these firms was to outsource or white-label algos from other brokers. Asset managers could choose to trade through these white labeled algos to help them meet their research commitment with these brokers.

In an unbundled world, we will likely see a reduction in the usage of white-labeled algos.

In an unbundled world where executing brokers must be selected based on their trading ability alone, we will likely see a reduction in the usage of white-labeled algos. Clearly, it will be harder for investment firms to justify routing orders to a broker who then passes those orders on to another broker. Our study confirms this, with 49% of traders indicating they will not use brokers who outsource their algos.

EXPECTED USAGE OF BROKERS WHO OUTSOURCE ALGOS



Note: Based on 55 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

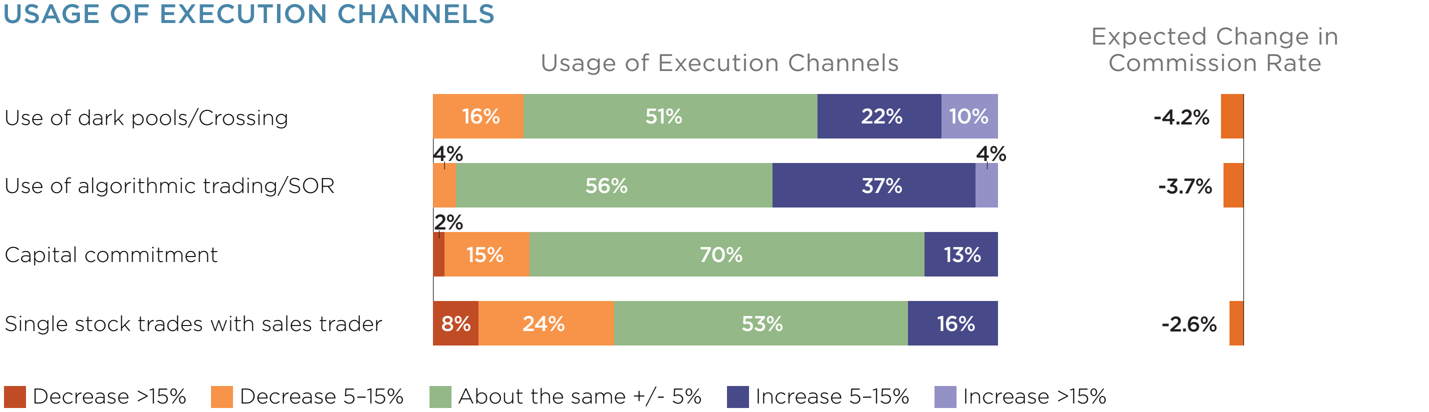
This type of business will not disappear completely, however. Although generally harder to justify, there are scenarios where it would make sense to use a broker who outsources electronic execution. For example, an investment firm may wish to route an order to a high-touch trader with expertise in sourcing liquidity. While that trader is searching for a natural cross, they would also wish to use the best electronic tools to work the order.

Low Touch Gets a Boost

Traders expect that a move toward full unbundling will result in a modest shift to low-touch channels. Over 40% of traders expect to increase usage of algorithmic trading, while just 4% expect a decrease. Most traders do not expect any change in usage for the different channels, although on balance, a very modest decrease in usage is expected.

And despite MiFID II rules being designed specifically to reduce dark pool trading, more traders actually expect to increase usage—with 10% expecting a significant increase. The new regulations impose caps on the amount of volume that can be executed in a dark pool using the "reference price waiver." However, dark pool trading using the "large in scale" waiver is not restricted under the new rules. It is this type of trading where we will likely see increases.

USAGE OF EXECUTION CHANNELS



Note: May not total 100% due to rounding. Based on 49 responses for dark pools/crossing, 52 for algorithmic trading/SOR, 46 for capital committment, and 51 for single stock trades.
Source: Greenwich Associates 2017 MiFID II European Trading Study

DARK POOL TRADING UNDER MIFID II

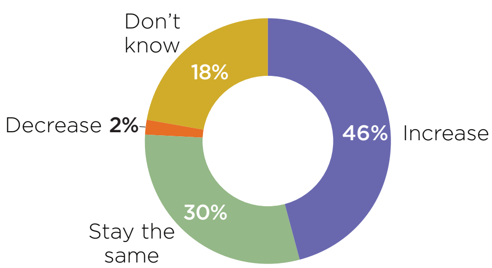
MiFID II Dark Pool Caps: New regulations set trading limits on dark trading using the "reference price waiver." Caps are set at 4% in an individual dark pool and 8% marketwide. If caps are breached, trading in dark pools using the reference price waiver is suspended for six months.

Waivers: MiFID I defined situations in which trading away from regulated markets and multilateral trading facilities (MTFs) was permitted. The reference price waiver permits dark pool executions when the execution price is derived from prices displayed in lit markets. The large in scale (LIS) waiver permits dark executions when the execution size is significantly larger than typical execution sizes (thresholds are defined by the European regulator ESMA based on ADV of the stock).

Systematic Internalisers: The systematic internaliser (SI) regime was introduced by MiFID I. Under MiFID I, systematic internaliser meant "an investment firm which, on an organized, frequent and systematic basis, deals on own account by executing client orders outside a regulated market or an MTF." Under MiFID II, systematic internalisers are required to make firm, public, two-sided quotes at standard market sizes.

Reflecting this, we expect to see an increase in the use of conditional order types. These are seen as an essential tool in facilitating the search for large-in-scale executions. Traders who want to trade in dark pools will need to execute in larger sizes in order to qualify for the LIS waiver. And yet, if they break orders up in order to participate in as many crossing networks as possible, the order size could end up falling below the LIS threshold. Therefore, traders will utilize conditional order types that allow them to participate in multiple pools without routing fully committed orders to each pool. (A conditional order type conveys a willingness to execute. If a contra order arrives in the dark pool, the conditional order is triggered and firm, executable quantity is routed automatically from the buy-side trader's blotter.)

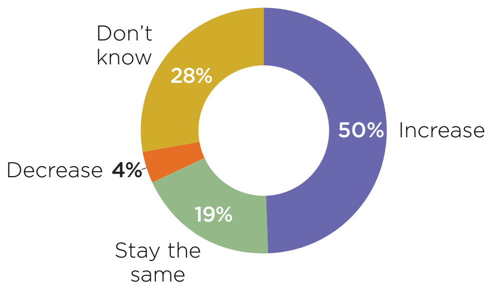
USAGE OF CONDITIONAL ORDER TYPES



Note: Based on 54 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Similarly, usage of systematic internalisers is expected to increase under MiFID II. With restrictions on dark pool trading, SIs are seen as valuable liquidity pools that traders are expected to take advantage of. Half of all buy-side traders expect to increase usage of SIs, and only 4% expect a decrease.

USAGE OF SYSTEMATIC INTERNALISERS



Note: May not total 100% due to rounding. Based on 54 responses.
Source: Greenwich Associates 2017 MiFID II European Trading Study

Recent controversy suggests that SIs will indeed be an important feature of European market structure going forward: Certain market participants were concerned that brokers could link multiple SIs together and create a de facto multilateral trading facility (MTF) while circumventing MTF regulations. ESMA has since issued guidance indicating that this will not be permitted. Nevertheless, this indicates the key role that SIs could have in liquidity provision under MiFID II.

SIs will also be able to make markets on a client-by-client basis at greater than standard market sizes without publicly displaying quotes. This implies that buy-side traders may prefer to interact with SI liquidity before routing to regulated markets or MTFs—a clear, unintended consequence of the new rules. In addition, ESMA guidance does not preclude technology vendors creating personalized order books for investment firms by aggregating feeds from multiple SIs. This practice occurs today in FX markets.

Conclusion

In the wake of MiFID II regulations, the trading landscape in Europe is set to get a major shakeup. While many firms in Europe profess to already being unbundled, the regulations will mandate unbundling region-wide and impose significant compliance obligations around this.

Selection of executing brokers will no longer be correlated to research provision, and most asset managers will be making changes to their broker-evaluation process. Quantifiable data on the quality of execution will be the most important single factor in the decision-making process, but the overall relationship will still have significant influence.

Some of the most controversial parts of MiFID II are the restrictions around trading venues.

The indications are that some trading will shift to low-touch channels and specialist electronic brokers, but that rates will remain approximately the same. Some of the most controversial parts of MiFID II are the restrictions around trading venues. The caps on dark pools are not popular, as traders feel they will constrain their ability to source liquidity. It is important to note that many stocks in Europe currently trade in dark pools at levels exceeding these caps. To compensate for a reduction in liquidity in certain types of dark pools, traders are expected to increase usage of dark pools aimed at block trading and of systematic internalisers.

With six months to go before the MiFID II effective date, trading desks are beginning to transform their processes and workflow. This effort will extend beyond January 3, 2018 evolving as the market adjusts to these expansive new rules. The only real certainties are that trading will continue to change, the buy side will continue to optimize their desks and brokers, venues and vendors will continue to compete for business.

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