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LIQUIDITY FRAGMENTATION ON LIT MARKETS

In a recent note The dark pool rises – A conflict of public interests, we analysed how the substantial share of trading carried out outside visible order books is increasing volatility and having an adverse effect on retail trading costs through spreads and liquidity. An important aspect to add to liquidity in that context is how it is being fragmented by increased competition among trading venues – or maybe not.

It is broadly undisputed that more competition among operators of trading venues has been to the benefit of investors in that it has reduced transaction costs. Critics argue, however, that the proliferation of trading venues – as a result of regulation – had a detrimental effect. According to this perspective, the Markets in Financial Instruments Directive (MiFID) in Europe, the Regulation National Market System (RegNMS) in the U.S. or similar regulations in other jurisdictions have given birth to arbitrageurs – with the effects of adverse selection on liquidity provision and thus price formation clearly outweighing the advantage of lowered transaction costs. In other words, the changes to the market structure as it existed until 2005 – 2007, aiming at increasing competition among trading venues did in fact distort competition since it caused a fragmentation of the trading interest once being concentrated at very few primary exchanges; plus, it incentivised the formation of high frequency traders that, in an opportunistic manner, exploit unsynchronised information between venues.

It is true that the share of high frequency trading (HFT) has risen sharply over the past decade, now accounting for an estimated 30 to 40 per cent of equities trading just in Europe. It is dishonest, however, to confuse cause and effect and to blame the number of venues for the emergence of HFT or market model imbalances, for some reasons. Firstly, this notion implies that the concentration of liquidity on very few, traditional exchanges had been beneficial to global liquidity. The portion of trading carried out over-the-counter long before new venues emerged, makes the above an invalid argument. The decrease in local liquidity (to use this term for the shrinking trading turnovers at traditional exchanges) would have had to be overcompensated by additional regulatory trading obligations for broad ranges of instruments, by a much more active retail trading community and by a number of other factors. It should be noted, by the way, that the advocates of a restoration of the old market structure deliberately keep quiet about the fact that it had been the primary exchanges, long trying to ignore the new competition, opened-up their platforms to HFT in the first place (meanwhile even appearing as buyers of HFT operators).

The most inconsistent aspect to the reproach of a regulatory-driven fragmentation of venues and, with it, liquidity, is that today's trading venue landscape is extremely heterogeneous. That is worth looking at in detail. As mentioned above, recent regulation has broadened the instrument scope subject to trading obligations and has introduced different types of venues for various classes of instruments. The so increased heterogeneity did however NOT have a detrimental effect on liquidity. The reason for that is simply that the new breed of venues (such as, e.g., multilateral trading facilities, MTFs) that are being accused of draining liquidity from traditional exchanges are lit markets.

On transparent trading venues, the increased competition and the overall results of regulation did also have effects on the suppliers of liquidity. On the one hand, the provision of liquidity became an unattractive business model for those that had been suppliers of massive liquidity earlier: the Basel rules on own funds made banks turning away from liquidity-provision since their proprietary trading business evaporated. Their place had been taken by 'real' liquidity providers the business model of which involves taking losses for the sake of providing liquidity, offset by the bid/ ask spread. Increased competition among them led to a reduction of their realised spreads which, in turn, has evidentially had a positive effect on global liquidity.

Dark trading, on the contrary, does indeed have negative effects on liquidity. The price at which stocks are being traded in the dark are derived from references at other, pre-trade and post-trade transparent venues (ironically, this includes primary exchanges to a large extent). If you accept liquidity as the ultimate measure for the informative value of the reference price of a given asset it is not so difficult to imagine the impact dark trading has due to not contributing to the lit market order book depth.

Hence, it is misleading to generalise a changing market structure under the negatively connoted term "fragmentation". Instead, it'd be appropriate to describe the process as 'specialisation' which, due to developing legislation, technological progress and changing consumer demand is inevitable (as other industries know full well).

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