Richard Semark, UBS MTF

Photos:Claudia Gannon

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Standing in MiFID's shadow

Brokers are past masters at adapting to regulatory change, but Richard Semark, recently appointed CEO of UBS MTF, suggests MiFID II could deal a serious blow to the quality of execution services in Europe.

Chris Hall

Despite becoming Europe's leading dark multilateral trading facility by volume since launch in November 2010, UBS MTF is under existential threat. MiFID II, the directive that updates the 2007 legislative framework for Europe's equity markets and its accompanying regulation, is widely expected to radically alter the current options for trading stocks off exchange. Nothing is certain. At the time of writing, the Irish presidency is seeking a compromise among the member states that make up the Council of the European Union before its powers pass to Lithuania at the end of June. To break the deadlock and finalise the council's text, Ireland has proposed a volume cap which would limit the amount of trading in a specific stock permissible on dark MTFs that use the reference price waiver. Member states have also considered banning client facilitation trades from equity-trading organised trading facilities (OTFs), a new category of trading venue introduced by MiFID II that would encompass existing broker crossing networks (BCNs). The measures could drain both dark MTFs and BCNs of liquidity.

But even that isn't the end of the matter: the council's version of MiFID II must be reconciled with that signed off by the European Parliament toward the end of last year. MEPs take a dimmer view of dark trading than member states: they want equity BCNs to be outlawed. It could take until the end of the year for the differences to be ironed out, with some now believing that 2018 is an optimistic implementation date for MiFID II, such is the weight and urgency of other macro-economic and financial infrastructure reform questions facing European politicians.

Not-so-hidden agenda

Unsurprisingly perhaps, UBS MTF's new chief executive, Richard Semark, appears weary of the MiFID II process, which has been taking up much time and effort by brokers since even before the European Commission issued its first draft for consultation in October 2011. Semark's concern is not so much the length of the reform timetable, more that the nature of discourse between the industry and the policy-makers has changed, poisoned by the billions spent by governments bailing out the finance sector since 2008.

"Unlike any other regulatory processes I've been through, this one has become heavily politicised," he says. "The normal approach – providing evidence and arguments through lobbying – is done with the knowledge the outcome might not be optimal, but at least the underlying objective is to make

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>
> *Richard Semark*

things better, i.e. reduce cost and make European markets globally competitive. All that now seems irrelevant."

For Semark, the agenda for many involved in the regulatory reform process is to "significantly reduce" the level of secondary market trading in European equities. As such, fears about widening spreads, greater costs of trading and lower liquidity are welcomed by many MEPs who fail, in Semark's opinion, to follow the logic through to consider the impact on long-term savers. "The danger is that regulation will constrain choice significantly and stop us from providing the services that clients want. I'm concerned we could end up with a much more homogeneous market, characterised by lack of innovation, lack of control, lack of choice and reduced transparency, which will lead to worse execution quality for clients. This will lead to less liquidity which will hike trading costs, resulting in a further drop of liquidity, a vicious spiral," he says.

Unfinished business

But what of the hitherto successful UBS MTF, which became the biggest dark MTF in Europe in July 2012 and traded its most value in a month in May 2013? Will it thrive alongside the new OTF regime under MiFID II's as-yet-unfinished framework for equity trading in Europe?

UBS's first attempt to formalise the crossing services it offered to clients was UBS PIN, an off-exchange liquidity pool to which it sent client orders facilitated by algorithms in the hope of finding a match. Orders that could not be crossed within PIN were routed onto the primary exchange and, as they emerged, other lit MTFs such as BATS Chi-X Europe.

But two things happened as a consequence of the burst of creativity sparked by the introduction of MiFID in 2007 that led UBS to reassess its liquidity provision strategy for institutional clients. First, the sources of liquidity became more fragmented and difficult to navigate; second, the regulatory environment began to turn colder toward innovation, in response no doubt to the unfolding financial crisis, but also to the unexpected rise of dark pools and high-frequency trading.

According to Semark, the decision to set up UBS MTF (first announced in March 2010) was prompted both by a desire to provide clients with access to a wide range of liquidity, but also to restrict access to PIN, in contrast with other broker crossing networks that included a wider spectrum of flow.

"We felt that setting up an MTF would give clients a better way of accessing additional dark liquidity than just going into the existing dark pools and a better way

Aggregation aggravation

While MiFID II might be the most clear and present danger to effective dark execution, Owain Self, global head of algorithmic trading, UBS, believes the rise of aggregation services from technology vendors could damage execution quality. "Because clients are under pressure to lower costs and improve efficiency, they are increasingly asking vendors to aggregate broker-side liquidity. This is dangerous for two reasons," he says. "First, clients may not have the resources to analyse and contextualise the execution data they're getting back from different pools. Second, the more the client limits discretion over execution and treats the broker as a venue, the less opportunity the broker has to influence the quality of the execution outcome. The high-quality crossing service brokers offer as part of their overall execution services is put at risk by these aggregators. There are implications if regulators start to view brokers as venues similar to exchanges."

These services have grown in popularity in the last 6-12 months. Whereas a client would normally pass detailed instructions to a broker on how they wanted an order to be executed, i.e. which dark pools, counterparts and algos they considered suitable, increasingly they are keen to see the liquidity other brokers have to offer. To avoid sending multiple orders into the market via different brokers and risk market impact and ultimately being overfilled, some firms are using services offered by some technology vendors and agency brokers to slice up a whole order across a number of brokers. One benefit of such services is that you don't have to react manually as the fills come back; the aggregator does it automatically.

"But the broker loses discretion over the order flow, which is the key to quality of outcome. The difference between the broker deciding when and where to cross the order as part of the execution service and an exchange matching an order is the exercise of discretion by the broker to improve the performance for the client," Self explains. "In the short-term, the client gets a worse execution, in the long-term the regulator will have a stronger case for closing down a non-discretionary execution service."

While Self worries about a race to the bottom in execution quality, Semark asserts aggregation services also give rise to some perverse incentives. "Because they direct more order flow to the broker that starts executing first, the discretionary anti-gaming approach that a broker might normally take will reduce the flow they see. That means there is an incentive to expose the client flow as quickly as possible to as wide a range of liquidity as possible," he says. "We use our client knowledge to strike a balance between the amount of liquidity they access, the immediacy of trading and the quality of execution. Under an aggregation service, there is no incentive for us to do that."

"The regulator will have a stronger case for closing down a non-discretionary execution service."

Owain Self

of accessing bid-and-ask liquidity than just going to the lit markets," he explains. To offer diversity, broker flow that had historically been in PIN was directed to the MTF, while UBS also went about attracting a wider range of external members. While UBS PIN only contains discretionary algo flow (some from internal users of UBS algos), UBS MTF allows clients to access liquidity arrangements more non-discretionary in nature. Because it operates a bid-ask book as well as a mid-price book, UBS MTF attracts a mixture of members: some are liquidity providers, some liquidity takers; some use the pool for price improvement, some use it as one option among many to get an immediate execution. "Part of the reason for its success is there is no single type of flow: it comes from buy-side clients, brokers, liquidity providers and prop firms," says Semark. UBS client flow in the MTF includes some flow from clients that do not have access to UBS PIN, "because they pursue

Richard Semark, UBS MTF

Owain Self

- Joined UBS in 2000
- Previously co-head of UBS European Automated Trading since 2007
- Served as European head of algorithmic trading
- Previously worked on sell-side trading desks, including at Daiwa Europe

Richard Semark

- Joined UBS in 2004
- Worked at AXA Investment Managers and UBS Asset Management for 17 years
- Served as a director of Turquoise and was member of the IMA dealing group
- Sits on the AFME Equities Board

execution strategies we don't think are appropriate for PIN".

Hit the brakes

The twin dark pool approach has two key strengths, says Owain Self, global head of algorithmic trading, UBS. "We felt that the level of transparency provided by running a BCN and an MTF was good commercially, because it helped clients understand the kind of flow they were interacting with," he says. But UBS's liquidity strategy adhered closely to MiFID too. "Other brokers have co-mingled different types of flow in their BCNs and as a result the regulatory framework for dark pools has come under a lot of scrutiny. If everyone else had operated in the same way as us, dark pools would not be under anywhere near as much regulatory scrutiny as they are now," Self argues.

Regulatory scrutiny, however, has been growing in intensity for some time. Semark suggests that the European Securities and Markets Authority effectively put the brake on developments in dark pool functionality as concerns were raised over price discovery in the lit markets.

"For example, initially order books were permitted to integrate dark and lit order flow, but that was stopped after 12-18 months. Dark MTFs can only execute at bid, mid and offer, although there have been attempts to broaden that through charging structures. Fairly quickly the debate moved from innovation to constraining the growth of models," he says.

Self agrees that dark MTFs have limited scope for differentiation in Europe; even when the regulator permits one venue to operate in a particular way, this has not been allowed to serve as a precedent for others. The pressure built up by regulatory constraints on MTFs has found release through innovation in brokers' execution services, including their BCNs, with clients demanding more variation in terms of the type of flow they interact with and how they interact with it. But Self fears that regulators do not appreciate the difference between non-discretionary matching on an exchange and crossing by a broker as part of an execution service. "The only appropriate regulatory framework for a service that accommodates these kinds of specific individual client requirements is one focused on broker execution."

Double trouble

But MiFID II is very likely to place crossing networks like UBS PIN under an exchange-like regulatory regime for OTFs. While MEPs want to outlaw BCNs for equities trading, forcing them to re-register as MTFs or systematic internalisers, member states have been looking at ways of improving transparency and managing their growth.

"It might not necessarily fit our model, but a good outcome would be an OTF regime that provides very clear guidelines about what brokers can and can't do with their BCNs, i.e. no co-mingled flows, greater transparency on how orders are executed, but continued discretion over order flow, so a client can choose whether to expose their order flow to high-frequency flow," says Self. This is similar to the US, where Reg ATS is prescriptive on controls and processes, but the broker – as long as he stays with certain constraints – retains discretion. Under that kind of OTF framework, he says, UBS could consider pooling the flows currently contained in the UBS MTF and PIN in a "structured, transparent process" that permitted control over participant interaction.

But the market may well go to one of two extremes. "Either we will have no BCNs and all that flow will be directed into MTFs, which would be negative from a client execution perspective; or we will have an OTF regime in which the bar will be raised in terms of only trading at a larger size. We're pretty well positioned with a BCN and an MTF to adapt, but we won't be able to offer the same execution service to clients if they remove BCNs or raise the barrier to MTFs, via changes to pre-trade transparency waivers," Self warns.

UBS MTF

- Pegged orders only
- No minimum order size
- Interoperable with two central counterparties: SIX x-clear and EuroCCP
- Record day: 19 March 2013 with €604 million value traded on 73,000 trades
- Average price improvement for May 2013: 4.45 bps
- More than 3,250 large, mid and small cap stocks traded
- 58 international depositary receipts from 14 underlying countries

Both Semark and Self accept the need for regulation and indeed suggest a greater role for market supervisors to create and maintain a trading environment in which best practice is encouraged through greater transparency, comparability and choice between service providers. At a time of unprecedented regulatory change in the market, the irony is not lost on them that the consolidated tape that would enable institutional investors to compare prices more easily across European venues is no nearer.

Lack of transparency

The lack of a consolidated tape is not the only barrier to buy-side firms' pursuit of best execution.

Many investment institutions try to decide which dark pools to use based on evidence of execution, but the number that can do that themselves is limited because they don't have the expertise and their available data set is limited.

Moreover, because of variations in the kind of flow different brokers allow into their BCNs, it is extremely difficult for clients to make a like-for-like comparison between the ability of competing brokers to provide access to dark liquidity, says Self. "The lack of transparency means that clients are faced with huge variations in the data sets on which brokers' dark pool execution performance metrics are based," he adds.

Semark acknowledges the problems in comparing analysis provided by UBS with that of another broker despite the progress of efforts made to standardise TCA, arguing that regulators should focus more directly on the needs of end-investors. "Over time, clients have become more adept at understanding how their orders are handled. A regulatory process which enhances competition for client flow by increasing transparency of brokers' order handling would be very good. If you have better information and the ability to make choices you will have better outcomes."