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MiFID II: Navigating the Emerging Liquidity Landscape

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A-Team Insight

Introduction

As with much of MiFID II, the September 1 deadline for implementation of the Systematic Internalisation (SI) regime, for equities and bonds* marked just the beginning of a new EU-wide liquidity landscape brought in by the sweeping regulatory change. Firms on both sides of the SI equation – those firms who are registered as operators of SIs and those on both the buy- and sell-side who may find themselves a counterparty to an SI – are just now beginning to grapple with the implications of this new regime. And while quite a lot of ink has been spilled and brain cells fried – by regulators, regulated entities, analysts and journalists alike – on the process of creating and operating these entities, it remains unclear what the long-term prognosis is for Systematic Internalisers and their impact on liquidity in European financial markets.

Navigating these waters in the coming months will be challenging for all concerned. SIs are fighting for attention, market share and liquidity with recognised trading venues – regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs) – as well as with specialist execution facilities like periodic auctions and other lesser-known trading approaches.

This white paper draws on an A-Team Group survey with both sides of the market – executives at registered SIs and those with firms who expect to trade with them. It looks at the current state of play as the new SI rules take effect, offering insight into how this new trading landscape is evolving. It will also explore some of the challenges firms are facing, including:

- Understanding how the users of SIs are viewing the range of execution choices on offer, including RMs, MTFs, OTFs, SIs, periodic auctions, and others.
- How both SI operators and users are investing to operate in this new ecosystem.
- How both SIs operators and users are thinking strategically about SI engagement, both now and in the medium-term.

While MiFID II makes it clear that SIs are of importance to the EU's liquidity landscape, this white paper unearths market players' concerns about the functionality and longevity of SIs, and how they are addressing those concerns. The paper first looks at how existing and potential users of SIs view these entities, and then turns to how the SIs themselves are developing their offerings and envision the future. Finally, the paper will conclude with a discussion of ways in which SIs, and their users, may need to evolve in the months ahead.

It is early days for MiFID II as a whole – and particularly for the SI regime. The interviews with key industry executives indicate that the European trading landscape's tectonic plates are definitely shifting. Where they will ultimately settle is still open to speculation, but one thing is clear: those changes are far from over.

** Per ESMA, the publication of the data for the SI calculations for derivatives and other instruments will start on 1 February 2019.*

Understanding Users of Systematic Internalisers

A View of the Landscape

MiFID II defines an SI as a firm that deals on its own account by executing client orders on instruments outside the scope of regulated markets or MTFs and does so on 'an organised, frequent, and systematic basis'. In essence, an SI matches client orders against its own books.

Under MiFID I, which originally introduced the concept, relatively few entities registered as SIs. At the time, back in 2008, SIs were only authorised for equities, with categorisation dependent on qualitative assessment. MiFID II has introduced new quantitative assessments for SIs and has expanded the scope to equity-like instruments, such as depositary receipts, certificates and exchange-traded funds, as well as nonequity instruments such as bonds, derivatives, emission allowances and structured finance products. However, the publication of data for exchange-traded commodities (ETCs), exchange-traded notes (ETNs), structured finance products (SFPs), securitised derivatives, emission allowances and derivatives has been postponed to 1 February 2019. As a result, SIs will be required to comply with those obligations from 1 March 2019.

Firms that become SIs are subject to MiFID II obligations covering (in most cases) pre-trade transparency, best execution, and – crucially – trade and transaction reporting.

There are two ways to become an SI – on a voluntary basis, or to be required to do so by the regulator. Firms are required to become an SI based on the volumes they trade in a particular instrument or instrument category. On August 1, ESMA published information on the total number and volume of transactions executed in EU markets for the first time, covering the period from January 3, 2018 to June 30, 2018; current SI threshold checks are based on this data. On September 1, 2018, firms had to register as an SI based on the assessment of whether they exceeded the thresholds, which determined their SI status. Subsequent assessments must be made on a quarterly basis, following EMSA publication of SI denominator data on the first calendar day of February, May, August and November.

In addition to SIs, there are three categories of trading venues under MiFID II:

- **Regulated Markets** – These are defined as multilateral systems that are managed by a market operator. They bring together multiple third-party buying and selling interests in accordance with set rules to create contracts. So-called 'traditional' exchanges fall into this category.
- **Multilateral Trading Facilities (MTFs)** – MTFs are non-exchange

European financial trading markets that bring together multiple buying and selling interests in financial instruments. MTFs also existed under MiFID I, although MiFID II does make some changes in MTF guidelines.

- **Organised Trading Facilities (OTFs)** – OTFs are a third type of multilateral trading system in which multiple buying and selling interests can interact to make contracts. OTFs are distinct under MiFID II, however, because they are used only for bonds, structured finance products, emission allowances or derivatives. Regulated market operators may operate OTFs, as may interdealer brokers.

As part of MiFID II's broader attempt to shift liquidity to 'lit' markets from the more anonymous execution venues known as dark pools, the popular broker crossing networks (BCNs) were eliminated and so-called 'double volume caps' imposed on dark pools, which has led to a flight of liquidity away from those platforms. This latter strategy appears to have been successful. One SI operator at a major sell-side institution said that in 2017, traditional dark pools accounted for about two-thirds of the firm's trading volumes. This dropped by 50% before the dark pool double volume caps went live on March 12; today, just one-twentieth of the firm's volume goes through dark pools.

According to the interviews with potential and existing users of SIs, regulated markets remain the favourite way to trade. "We have tried to stay on exchange in most cases," says one operations director at an investment bank. "Regulated markets are holding their own," says another user. MTFs, periodic auctions and SIs form a clear second tier of trading location in terms of preference, with OTFs seen as less appealing to those interviewed.

For potential and existing users of SIs, the jury remains firmly out in terms of just how attractive SIs are as a potential counterparty. Nearly all users said that they viewed the growth in the number of SIs across the range of instruments, as a result of MiFID II, "neutrally." No respondents said they viewed this development either very positively or even positively.

SIs vs. Periodic Auctions

That said, some executives see benefits to using SIs. One user said his firm was effectively changing from using BCNs to SIs because of the increased transparency. "When we were trading on BCNs, we would get an execution that was not very transparent," says one head of trading. "Now we can see who is doing it – an internal, external SI or another buy-side client. That is very helpful – the transparency has definitely increased."

However, other firms remain to be convinced that they should shift their liquidity to SIs, and are instead looking to periodic auctions. According to the UK's Financial Conduct Authority (FCA), periodic auctions are where the operator – often an exchange, or regulated market – collects offers to sell shares at or above a minimum price and buy at or below a maximum price specified by the selling or buying firm, respectively. The auction platform then determines a single 'uncrossing' price that maximises the amount of business executed at the same uncrossing price.

Although an FCA study says the rise in the use of periodic auctions isn't related to the advent of the double volume cap for dark pools, users we spoke to said there was a relationship. For example, the firm quoted above that has slashed its trading in dark pools has moved a significant proportion of its flow to periodic auctions: nearly one-quarter of the firm's trading is now going through periodic auctions, compared with no volume in 2017. In comparison, just one-in-ten of the firm's trades have gone through SIs during 2018. Says an executive at another firm, "I think we will see more of a move towards greater usage of periodic auctions now that a lot of the dark pools are becoming restricted."

The attraction of the periodic auctions may be the reduced levels of pre-trade transparency. Others say they are just a very good way to get a job done. Says one executive: "We are trading through periodic auctions a lot more than before. In the products we trade, they are a good source of liquidity for market-makers to clear risk at a low cost, and clear the balance sheets." He adds, "As data is getting much better and more timely, the auctions' prices are better, so there are more people who want to be involved mid-price."

Other firms remain sceptical about the benefits of SIs and say they are looking for other alternatives. Says one user, "With SIs, there is an awful lot of opacity and obfuscation about what they are doing. It is very difficult to get a real feel for the type of liquidity that is being offered there. So, in terms of trying to figure out whether it's passive unwind liquidity or whether it's risk liquidity that the banks are offering, it's been very difficult to get a feel for whether executing on an SI is a good thing or a bad thing."

Looking at the Two Types of SIs

Users are also making distinctions between the two types of SIs. The first type are SIs that are operated by investment banks, either because they have been caught up in MiFID II's SI threshold regime, or because they have decided to become an SI in an area to remain competitive or due to client request.

The second type are SIs operated by electronic liquidity providers (ELPs), such as Citadel Securities, Virtu Financial, Jane Street Financial, Jump Trading, Tower Research Capital Europe, XTX Markets, and Sun Trading International – now part of Hudson River Trading.

Potential and existing SI users say they expect different approaches to the market from the two different types of SI. One user, for example, believes these investment bank-based SIs could be charging more than the ELP-based SIs, and he says they are not as transparent as he would like them to be about the source of their liquidity. The reputational damage that has hit some firms over the past few years is also a factor – he says the regulatory actions make him and his firm more circumspect when working with investment banks who are SIs. This user's firm, when it begins to access SIs, will be only accessing ELP-based SIs.

Some executives suggested that investment banks may be using the investment in SI technology infrastructure to bring together various pools of liquidity across their organisation, and so for these institution becoming an SI helps them achieve an additional goal. For users, however, this can then be confusing to trade with as they do not know where the trade is coming from, what kind of a trade it is.

Several users made the distinction between SIs run by investment banks and ELPs, indicating they felt that the latter group may be less expensive to engage with because they don't charge commission and offer a higher quality of liquidity. The ELPs, in many cases high-frequency market-makers or liquidity providers that are relatively new to the SI concept and have a different organisational structure, can appear more straightforward to deal with.

Another user says, "SIs are good for smallish blocks (like BCNs), but not hugely better than old dark venues. We target them as we did dark venues, as far as a client allows. The ELP-SIs, though, are more interesting. They are willing to put up larger amounts/prices where we can provide certain types of liquidity. In other words, they'll work with us as this has been their business model for years." This distinction between the two types colours much of what the user side has to say about working with SIs.

Drivers for SI Engagement

All of this means that the future for SIs as a phenomenon is a bit uncertain. When asked, in three years' time, which types of trading venues their organisation would be using more or less frequently, all participants said they would be using periodic auctions "much more frequently" or "more frequently." One user said that more liquidity would move to periodic auctions, so that they would become the "de facto standard… We will see more stuff going back onto exchanges and periodic auctions over time."

At the heart of the issue, driving trading venue decisions for users, are two primary factors – best execution demands and liquidity:

- **Best execution** – One user firm executive said best execution was "very, very, very, very, very important," adding: "If performance is good, brokers will execute more. If performance is bad, they will execute less." Several users indicated that a wide range of performance statistics are consulted as part of determining best execution, including "reversion" – a measure of how quickly the price moves when a user trades, and then how quickly it reverts back to its original level? This reliance on data and statistics means nearly all participants found best execution somewhat challenging, with a minority finding it very challenging. No respondent firms found it "not challenging."

  Technology infrastructure, as well as obtaining and using data correctly, were the top two key challenges reported. In second place, as key challenges, were compliance policies and procedures, as well as communications with/transparency from the venue. Several respondents selected all five possible responses, which included the challenge of the regulatory reporting process as well.

  For most, a combination of technology and employee training are being used to ensure best execution requirements are met. Says one head of execution sales, "It all hangs together. If you get the technology right, then you have the right data. If you have poor technology, then you have data breaks, etc. It all hangs very closely together. It is like one big organism that sits there hanging over our heads every day."

- **Liquidity** – The current environment for liquidity is clearly in flux. Users were unanimous in saying that the more venues there are for trading, the more fragmented liquidity will be. In this sense, none of the users saw the development of SIs as particularly useful in consolidating liquidity – instead, they expect SIs to be responsible for further fragmentation. Firms are connected, on average, to between seven and 35 trading venues, but they are keen to consolidate. Most of those interviewed saw the number of venues they are connected to either staying the same or decreasing over the next three years. Says one user, "Accessing liquidity is more cumbersome and onerous. There is severe fragmentation between, say, periodic auctions, 10 or so SIs, four major brokers, all the regulated markets and conditional pools. How sustainable this is, is questionable."

Users also spoke of the market polarising between large-in-scale (LIS) trades and smaller trades, with the smaller end becoming "trickier to trade in" as a direct result of the changes MiFID II has made to the market structure. With liquidity this challenging at the moment, it's clear why obtaining good liquidity to trade in is even greater a priority than usual for user firms.

Users are struggling to understand how to evaluate SIs against other trading venues, in part because they are approaching best execution differently. "How do you evaluate different types of SIs? With an SI, there is no such thing as 'an SI' – there are several different types of SIs. They are not all the same. People are trying to evaluate them as one bunch but actually that doesn't work at all." He adds: "The broker's smart order router, when they are deciding to trade with an SI or not, how does that methodology work? Do they favour a lit exchange first, do they favour their own SI first, or do they truly look at all venues agnostically before taking a decision as to where to route?"

Other drivers of trading venue decision-making for users were seen as less important. On a second tier of responses were regulatory reporting requirements, the compliance cost/burden, and any customer request as to trading venue. Best execution concerns trump regulatory reporting when it comes to regulatory compliance priorities for users – negating a key advantage that many SIs had hoped to have, which is their ability to supply MiFID II trade reporting to regulators on behalf of those they trade with (see Section SIs – The View From the Inside, below). Nearly all users who were interviewed said regulatory trade reporting played no role in their decision as to where to trade.

Looking Forward: The Outlook for SIs

As with past instances of market and liquidity fragmentation, executives interviewed for this report expect to see an initial flourish of SI launches followed by a period of consolidation finally settling on an appropriate number of 'best of breed' operators.

Half of those interviewed said that in three years' time they expected their trading with SIs to be about the same or possibly less, though not necessarily with the same players they interact with now. Asked how they thought the number of SIs will change over the next three years, most respondents said they expected numbers to "decrease somewhat."

Said one SI user, "We haven't reached a peak yet, but you don't need that many. A lot of them are imitating each other, so where we will end up is a situation where there will be best of breed by the end of 2019. You will see a significant reduction in SIs by then."

At the most SI-enthusiastic end of the spectrum of respondents, user firms are cautious, and are taking a strictly evidence-based approach. Says one user, "If the data continues to come out and continues to support what they are doing, sure, we will wind up using them more than we do at the moment. We could wind up taking a direct connection to them rather than going through a broker's decision tree. We might have more direct connections to underlying SIs, so we might use them more. But their data is going to have to support it."

However, most users expect competitive consolidation among the SIs – particularly among those run by investment banks. They see this as a direct result of most liquidity consolidating at regulated markets and periodic auctions.

Says one user, summing up his firm's approach: "We see things moving more towards exchanges rather than SIs. Therefore, we will only use SIs where it is appropriate because that is where the liquidity is right now. Over time, however, we think that they will gradually disappear." Another user believes that the SIs run by investment banks will be the ones that will close up shop. He adds, "The active ones – the ELPs – will remain as they have been doing this for years and they are good at it."

Overall, the outlook for SIs from the user's perspective is not particularly cheery. Users view SIs as further fragmenting liquidity, as less transparent, and as a potentially unsustainable trading business model. User firms are focusing their decision-making on where to trade on what the data tells them – and this seems to be steering them towards regulated markets and periodic auctions. Scepticism about how SIs will function is high, at least for now.

SIs – The View from Inside

ELP SIs – Significant Potential Ahead

Electronic liquidity providers (ELPs) seem to be positioned to benefit more in the short term from the new MiFID II regime. Several of them were ready, with their SIs in place, for the 3 January MiFID II launch. They have also been marketing themselves actively to potential users. Many are holding lots of face-to-face meeting as a way to gain buy-side trust, and it seems to be working. Quite a few of the users spoken to for this white paper said they would prefer, for now, to trade with the ELP SIs, rather than the investment bank SIs.

The ELPs may have other advantages too. Most of them were set up with the past decade, which means they could take a greenfield approach to building their technology infrastructure. As a result, most have been able to more easily adapt to the demands of MiFID II than the investment banks. The investment banks are struggling in many cases with legacy IT infrastructure that means firms often don't have a good view of their own internal liquidity, and they are relying on the MiFID II SI investment to create that visibility (see below).

These factors add up to a significant competitive advantage for the ELP SIs, and many are anticipating they will succeed in the new MiFID II regime. Already, deal flow is beginning to gravitate to them – and while that flow is less than that for the bank SIs, their share is anticipated to rise. Those interviewed for this white paper seemed to be clearly saying, "watch this space."

A Tale of Two Investment Bank SI Types

Investment banks that were interviewed for this whitepaper – those that either have existing systematic internalisers (SIs) or are in the process of launching one or more – seem to fall into two categories. First, there are what could be called 'reluctant SIs' – firms in which the decision to become an SI came either as a result of regulatory pressure or the firm's meeting of the volume threshold. These firms are picking and choosing where they might set up additional SIs, and are generally still in the process of completing set-up of their SIs.

For example, one firm interviewed has an SI for fixed income in place – it was clear that it would need to create this because of its market position. However, two other SIs – one for cash equities and another for equity derivatives – will be coming online much later in the year. The firm is moving to its own internal timetable, rather than to MiFID II's. Another firm is considering opening an

SI for certain OTC derivatives, but senior management hasn't taken the final decision. Mostly these are regional investment banks that are fulfilling their regulatory obligations but then taking more of a 'wait-and-see' approach to the development of the SI paradigm before launching more in other asset classes.

Secondly, there are firms who are going all-out in their approach to engaging with the SI model, the more 'enthusiastic SIs'. These firms often already have SIs across a number of asset classes – for example, one firm had SIs in place covering more than 90 individual instruments or instrument sets.

For the most part, these are larger, international investment banks. Most would have had to create SIs based on the MiFID II thresholds, but many are going well beyond those obligations. These institutions have made public announcements about the SI areas they are moving into, and are keen to be successful in the SI space.

All of those interviewed – both the reluctant and the enthusiastic SIs – said they saw being SIs as a key part of their business model going forward. All also said that they have decided to become SIs to remain competitive in the instrument or instrument groups that they have become an SI for. Most firms also indicated that the SI would help them better service existing clients. Very few said that the motivation behind this strategic move was to attract new clients, or to gain economies of scale for their investment in mandatory SI infrastructure – or to implement a new, SI-driven business model.

With the smaller, regional players – who make up the bulk of the reluctant SIs – it's clear that there is an element of regulatory compulsion in becoming an SI, even though those we interviewed said that becoming an SI is of strategic importance. Often these firms are significant players in their domestic markets for debt, equity and derivatives on those domestic instruments.

As a result, regulators want to see key regional players become SIs in those domestic markets. These regional players are forced to comply, and then make the best of the situation by seeking the strategic benefit. A few of these firms even went so far as to say that in the non-domestic markets in which they trade, where they themselves are not a dominant player with an SI (so, for example, an Italian bank trading in Germany), they are actually avoiding trading with SIs because they don't think the SIs there are the best places to do their trades. So, these SIs are taking a cautious view of the benefit that other SIs can bring in other markets – which perhaps hints at a level of circumspection in how they themselves behave as SIs.

For the larger, international banks, becoming an SI is driven as much by their regular flow of trading as it is by regulatory requirements. Says one SI executive, "We do all sorts of execution activities on both an agency and a principal basis across all asset classes. Whenever we trade on a principal basis, including market-making and providing the liquidity of our central risk book, then we do that in an SI capacity." Says another executive, "We see access to liquidity and the ability to offer risk pricing – all afforded by being an SI – as key to our business."

Another reason for launching an SI is the desire to provide MiFID II regulatory trade reporting services for their clients, as an added benefit of the client relationship. One senior executive said, "Clients approached us – somewhat ironically – for the reporting aspect. We do the reporting as an SI and this is what the clients wanted." For these larger banks at the present time, having a raft of SIs in place seems to be considered part of their overall competitive positioning.

SIs – Keeping Up with the Neighbours

Certainly, there has been no shortage of public proclamations about SI intentions among investment banks of all sizes and shapes. While the public mood music firms are making about their SIs may be all positive, 'damn the torpedoes, full speed ahead' stuff, in private they are often more circumspect.

To begin with, SIs are ambivalent about just how much of a benefit being an SI delivers. Nearly all of those interviewed saw SIs as making their firms "more attractive" to do business with – only one said that SIs made them "much more attractive."

Like the SI users, the SI operators themselves also see the number of SIs falling over time. The most respondents saw the number of SIs in the marketplace staying level to the total on September 1 over the next three years, while others saw the numbers falling. Said one SI executive, "There could be some mergers, and a few new SIs coming in." Another said that he expects the SIs to follow the pattern of MTFs under MiFID I – a lot starting up when the regulation comes into force, but then there will be a gradual "falling by the side of the road." Says another player, "People will think, 'Why am I spending all this money?' For an investment bank, it's not really required, because there is not enough liquidity to justify the maintenance of the infrastructure. That's my gut feel."

Why the lack of enthusiasm, privately? Says one of the larger players, "The reason to become an SI is just to keep up with your competitors and because your clients want you to. A lot of buy-side clients will only deal with an SI so that the SI then takes care of the reporting requirements. So, the competitive aspect is just so that you don't lose the business. You aren't becoming an SI to move forward, you are only doing it so that you don't fall behind." In addition, SIs and users pointed out that even though SIs can provide MiFID II transaction reporting for the users of SIs for free, those users cannot select an SI venue specifically because it offers such reporting – the users must trade based on best execution. This reality has led to some disappointment among SIs.

And the cost of becoming an SI is significant. Half of the SIs interviewed for this survey put the bill for their firm of setting these up as being more than £10 million, saying that this money was spent on new systems or significant upgrades to multiple platforms. Firms generally spent the money on client order management system implementation, trade and transaction reporting solutions, acquiring the ability to publish quotes and change quotes rapidly, and building and maintaining new MiFID II compliance process and procedures. Said one of the larger players, "there has been lots of spending."

The size and scale of the spending required to become a MiFID II compliant SI is seen to be purposeful policy by the EU regulators, argue some in the market. Says one regional bank, "What MiFID II has kind of developed here is a move towards the larger scale players, so the bigger players are dominating and the smaller guys are falling by the wayside, because they cannot maintain the spend required and the investment in technology that is needed. The larger guys are able to scale up quickly. We are seeing that some of the smaller guys are falling by the wayside."

Best execution compliance, in particular, requires significant spending to implement. Almost all SIs interviewed said that implementing the technology infrastructure for best execution as an SI was a key challenge. For the larger firms, getting the different internal pools of liquidity to communicate and be transparent with each other, through the use of technology, is one of the biggest hurdles in terms of infrastructure development.

Firms may trade a certain type of instrument in different geographies or through different legal entities, and these different trades may have carried on in isolation prior to MiFID II, rather than being pooled together to create firm-wide liquidity. Says one of the international banks, "We have a lot of IT projects going on to bring in the various places that we have principal liquidity in the firm, which is in many different parts of the organisation, and plugging them into the SI, on the supply side." This can be a big challenge for smaller, regional investment banks too, where integration of internal pools of liquidity may be even further behind, in terms of the technological infrastructure.

However, this new internal liquidity will also be one of the biggest benefits for firms that are building out the SI infrastructure. Says one of the regional firms, "Building out our SI will improve communication and internal liquidity, because that will then open up different desks internally, where we can match through internal communications. So, there is going to be improved liquidity, pricing and cost of execution straight away from better internal communications." One of the larger firms echoed this sentiment, saying that becoming an SI "will help give us structure to more easily make our principle liquidity available to our clients in their regular trading."

Putting in place the right compliance policies and procedures took a distant second place in terms of key challenges, but it is still regarded as important. Says one of the regional banks, "One of the biggest challenges of MiFID II is interpretation. It's quite interesting to see how people have managed it. They published MiFID II several years ago and got feedback, but there were a number of questions that were never addressed… I'm waiting for ESMA to come out and start handing out fines to people, or raps on the knuckles, saying they have picked the wrong interpretation. I'm expecting to see this over the next six months."

This respondent is also expecting more guidance and rulemaking from the EU. He adds, "There are going to be some twists and turns because some areas are not working as efficiently as they should."

Firms also cited the difficulty of acquiring the right data. The challenge of obtaining the data from multiple sources, cleaning it, making sure the firm has access to the right information, and ensuring that trade reporting is performed correctly were all discussed as key issues. Says one executive, "A major challenge has been trying to understand what data is required for the different asset classes. We are still in the learning phase. In equities, we have a golden source of information but getting it was difficult. There is still work to do elsewhere."

One big area to watch will be the challenge of reporting under RTS 27 and 28 for the best execution regulations. Lining up the technology and the data for this reporting has proven to be a particularly large mountain to climb for some firms. Says another executive, "these were big, onerous projects."

In short, things are still very much in a state of flux from the perspective of the SIs as well. Certainly, some firms are further ahead in their preparations than others. However, even those who have hung out an entire shopping mall's worth of SI shingles seem to still be working to bring all of their internal liquidity online through new technology systems. It's still very much early days for SIs. Just how things will shake out for the SIs remains to be seen.

Looking to the Future of SIs

It's clear from the current state of play in the SI ecosystem that these types of market players are still very much a phenomenon in motion. On the user side, there has been a bit of a "rush to judgement" – with some user firms already predicting the demise of SIs. SI operators themselves are cautious, but certainly more optimistic than the user community is, and with good reason. For many firms, the work of consolidating their own internal liquidity will provide real benefits to the organisation itself as well as to SI clients.

However, for the relationship between SIs and their users to mature more fully, there are some challenges at the moment. Key issues that have surfaced as a result of the interviews with users and SI executives in this white paper include:

- **Transparency** – For SIs, transparency is key, in terms of the data that they publish – and that includes both price and performance data. This also extends to market understanding of which entities are operating as SIs in which instrument sets.
- **Technology** – SIs being run by investment banks are still in the process of enhancing their technology infrastructure to bring together internal pools of liquidity. So, what investment bank SIs are able to offer in the future, in terms of liquidity, may be better than what they are offering at the moment. It may be a good idea for the trading community to continue to watch SI performance data and see what happens.
- **Strategy** – The decision to become an SI is mostly being driven either by a regulatory imperative of some sort, or by a need to "keep up with the Joneses". The user-side sense the ambivalence inherent to these approaches and are wary as a result. SIs need to demonstrate the benefit of trading with them.
- **Best execution** – This aspect of MiFID II is one place where the rubber meets the road for both SIs and their counterparties. Users of SIs want to see the right best execution indicators before they will engage. And SI-operating firms need to get best execution right both internally and externally. Best execution reporting – RTS 27 and 28 – is another significant challenge.
- **Liquidity** – Becoming an SI provides clear benefits for firms, by creating a single pool of internal liquidity. SIs need to be able to figure out how to translate that benefit into the kind of liquidity that their clients will want to see to do business with them.

For both SI users and for SIs themselves, the right data is essential to all of the above key issues. Producing the right data will help SIs establish a firmer foothold in the MiFID II trading landscape. At the same time, potential users of SIs will be able to better spot opportunities to trade beneficially with these entities only if they have the right data at their fingertips. In short, in a trading ecosystem that is evolving this quickly, having the right data is essential to staying on top.

How Thomson Reuters Can Help Market Practitioners Navigate the New Trading Landscape

Thomson Reuters has developed a suite of services aimed at helping users interact with the emerging community of Systematic Internalisers in the context of the broader European liquidity landscape. Key features include:

- Liquidity Analytics
- Reference Data for Instrument/Counterparty ID
- TCA and Best Execution
- Trade Aggregation/Identification for Post-Trade Reporting

Thomson Reuters and our partners have the content, technology and expertise to help you thrive in a MiFID II world of compliance and beyond. Thomson Reuters is uniquely positioned to enable our customers to fulfill their obligations and be competitive under MiFID II.

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