

## *Liquidnet on MiFID II*

### *Position paper*

#### *Introduction*

Liquidnet operates the largest block crossing system in the world, providing block trading services for equity securities in thirty-nine countries on five continents. We bring together leading asset managers on a single trading network. Our customers are primarily buy-side institutions, such as pension and mutual funds, which trade on behalf of tens of millions of individual European investors. Our average negotiated trade is more than 100 times larger than the average trade on the LSE, NYSE Euronext and other European exchanges.

#### *Why does what we do matter?*

Liquidnet addresses some of the major problems facing long-term institutional investors. We enable buy-side institutions to negotiate and trade large orders (also called 'block orders') directly with other institutions. This reduces trading costs for long-term investors seeking to execute these block orders. It also protects the confidentiality of the order information from High-Frequency Traders (HFTs) and other short term speculators. This all means greater market stability and higher investment returns for Europe's mutual and pension funds, as demonstrated by our performance over the past ten years.

#### *What impact is the new EU legislation likely to have?*

We welcome the Commission's initiative to revise and update the Markets in Financial Instruments Directive (MiFID). For example:

- We support a mandatory consolidated tape for last sale data;
- We support improved disclosure by dealers to customers regarding the handling of customer orders;
- We agree that RMs, MTFs and OTFs should all have the same pre-trade transparency waivers.

We are concerned, however, that some of the proposals might put our type of model at risk and thereby negate the benefits we provide to pension funds, mutual funds and others. Concretely we are concerned about the following three issues:

- Waivers for indications of interest (IOI);
- Stub disclosure;
- Minimum size for the reference price waiver.

In response to the latest consultation from the European Commission, **institutions representing tens of millions of individual European citizens** (and their various trade groups) **emphasized the importance of the various waivers for protecting individual long-term investors (see Annex 1 below).**

We also would like to ensure that the ESMA process for reviewing waivers allows for maximum transparency to the regulators regarding the scope of the waiver being proposed by a trading system.

### *Indications of Interest (IOI)*

We agree with the Commission's approach that actionable IOIs should be subject to pre-trade transparency obligations in the same manner as firm orders. In the initial proposal from the European Commission, there was a potential ambiguity as to whether IOIs could qualify for pre-trade transparency waivers in the same manner as firm orders. We appreciate that the latest proposal from the EC has clarified that IOIs will qualify for pre-trade transparency waivers in the same manner as firm orders, subject, of course, to meeting the necessary conditions for the applicable waiver.

If waivers were not available for IOIs, institutional investors currently using systems such as ours would lose the ability to automatically negotiate trade blocks directly with other institutions. This would mean that they would need to reveal their orders to HFTs and other market intermediaries that engage in short-term trading, ultimately raising the cost of trading and increasing the volatility of the markets. Accordingly, we appreciate the EC's decision to clarify this point.

### *Stubs*

Liquidnet believes that the Commission's intention of requiring the disclosure of stubs which do not meet a certain threshold would severely disadvantage institutions making large block trades. In many cases, an institution will complete an order but will have more to do on that order. Requiring disclosure of that order's remainder, the stub, could give information to High-Frequency Traders and other short-term traders that there is additional supply or demand in that stock. They can use this information to disadvantage institutional buyers and sellers, which ultimately harms the individual long-term investor.

As well as protecting institutions from HFTs etc., an exemption for stubs would:

- allow institutional investors to execute large orders over the course of the trading day to mitigate against the risk of bad execution; and
- enable institutional investors to avoid the unnecessary double ticket charges and market impact costs that stem from having to use a second broker to execute the residual stub of the order.

Buy-side institutions have been clear and consistent in their opposition to this proposal and Liquidnet would propose a compromise whereby the **LIS waiver would not apply if the stub is less than 25% of the applicable LIS threshold.**

### *Minimum size for a reference price waiver*

The proposal to impose a minimum size for a reference price waiver would restrict the ability to execute trades at the mid-point. The mid-point is the best execution price for a customer as it eliminates the 'spread' typically earned by dealers and short-term speculators. Mid-point execution is an important component of the cost savings that we provide to our institutional investors.

For context, in Europe 90% of our trades are executed at mid-point, providing 100% price improvement to both sides. We fear that imposing a minimum size for the reference price waiver would make it illegal for models such as ours to provide best execution to long-term investors. Liquidnet suggests that a **minimum size requirement should not apply where the trading facility provides 100% price improvement** (i.e. a mid-point execution). Stated differently, **it should not be illegal to provide best execution** for customer orders (i.e. a mid-point execution).

*Should you have any further questions or comments please contact us: [hmeyerson@liquidnet.com](mailto:hmeyerson@liquidnet.com)*

***Supportive comment letters from institutions that trade for tens of millions of European citizens***

*"Order stubs should continue to benefit from the large-in-scale waiver, as we believe that it may unduly affect the cost of trade and the initial execution methodology to treat stubs differently from the block trade that it originally formed part of."*

*"As an institutional buy-side investment firm, we wish to continue to benefit from the large-in-scale waiver to the maximum extent possible and would therefore favor the lowering of large in scale waivers thresholds (i.e. that a transaction will earlier qualify for a large in scale waiver than is currently the case). We are certainly not in favour of such thresholds being increased."*

- Shell Asset Management Company B.V.

*"We suggest that no change is made in the treatment of order stubs. If stubs were forced onto the lit market it would make the crossing of blocks far less likely and would drive execution costs higher."*

*"We suggest that the current pre-trade waivers continue to be applied to allow large block crossing to take place in systems such as Liquidnet, ITG and in 'broker dark pools'. Forcing this business onto the lit market without regulation of HFT activity and robust enforcement of the Market Manipulation directive, would drive execution costs significantly higher for large buy-side orders."*

- Standard Life Investments

*"Institutional investors use non displayed markets because they allow an opportunity to trade in size, and away from markets where their large orders interact with those placed by high frequency traders."*

- APG Algemene Pensioen Groep NV

*"There is a clear interactivity between transparency and the other features of strong, well regulated, efficient markets. As such, while it should be possible to improve pre-and post-trade transparency without materially impacting upon other necessary features such as liquidity and cost, the proposals could potentially have materially adverse, if entirely unintended, effects. In specific terms, the possibility that institutional investors may be denied access to large scale liquidity, such as those in dark pools, should be considered carefully."*

- Irish Association of Investment Managers

*"Institutional investors such as our members, trading on behalf of their clients who are policyholders or pensioners, are significant users of dark pools. They do this because they believe that is where they can achieve best execution for some orders. Being able to transact in size away from lit markets reduces the market impact and therefore transaction costs."*

*"We believe that stubs should retain large in scale protections and that MiFID should be clarified to ensure that they can remain dark. There is a risk that the exposure of a part of an order which remains unexecuted, and which may be just below the LIS threshold, will provide information to other market participants about the order as a whole, thereby frustrating the purpose of the protections afforded to the original order."*

- Association of British Insurers

*"We would argue strongly for all Stubs from initially dark Large in Scale orders to remain in the dark in order to prevent market leakage of sensitive information on on-going orders."*

*"We would urge that the Large in Scale and Reference Price waivers should remain in place in order to allow crossing networks and algorithms the ability to gain 100% price improvement for both sides of a trade, without imposing a minimum order size."*

- Baillie Gifford & Co

*"... we note that such a brokered MiFID regime should not result in limiting important trading abilities for investment firms operating for institutional clients. For instance, crossing systems and dark pooling are important instruments for some investment firms to execute their large orders. Regulating these trading instruments needs to be conducted with due care."*

- Eumedion

*"Undisplayed liquidity is not a new phenomenon. Funds have long been significant users of undisplayed liquidity and the trading venues that provide such liquidity. These venues provide a mechanism for transactions, particularly the large orders ICI members frequently must execute, to interact without displaying the full scale of a fund's trading interest. This, in turn, lessens the cost of implementing trading ideas and mitigates the risk of information leakage. These venues also allow funds to avoid transacting with market participants who seek to profit from the impact of the public display of large orders to the detriment of funds and their shareholders. The importance of funds being able to trade efficiently in large size cannot be discounted. As we have stated in several letters to the SEC, the confidentiality of information regarding fund trades is of significant importance to ICI members. Any premature or improper disclosure of this information can lead to front running of a fund's trades, adversely impacting the price of the stock that the fund is buying or selling."*

*"We strongly support the flexibility provided by pre-trade transparency waivers and the Commission's recognition that the reasons for allowing waivers still appear valid. We believe that any changes to waivers must be carefully crafted to not create difficulties for investors when executing orders."*

- Investment Company Institute

*"As a fund manager for large institutions, we routinely use BCSs for large orders to avoid market impact that might arise if other market participants were to trade ahead of our orders. We generally instruct firms not to display our orders where such non-display is judged to benefit execution quality."*

- Wellington Management Company

*"We state that the interests of large investors such as the pension funds and savings pools are not always served by lit trading."*

*"IMA members support retaining the current regime whereby order stubs remaining from a large in scale order to continue to benefit from the waiver.... We consider that ESMA should provide evidence for what may turn out to be an overly theoretical concern about a small value of orders."*

- Investment Management Association