The Swiss Stock Exchange

Finding a New Balance

Trading Swiss Equities – Lessons from "Non-equivalence" and Outlook for 2021

November 2020

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As the most extraordinary year of this still relatively young century comes to an end, we are hopeful that normality will return in 2021 to both our private and business lives. Unrelated to the Coronavirus pandemic, we expect one other aspect of business to return to normality. Brexit is likely to resolve the inability of European MTFs to trade Swiss stocks, which was caused by the equivalence discussion impasse between the EU and Switzerland in 2019. Following the Brexit negotiation deadline, a bilateral agreement between Switzerland and the UK is expected to be struck, which is very likely to result in London based MTFs re-admitting Swiss stocks to their trading universe.

It is a result which is anticipated and welcomed by market participants and arguably, it is also favorable for the industry. I believe that competition pushes us forward and keeps us close to market participants. The competitive aspect of equity markets is something that we have embraced for many years. As such, we have been operating the Swiss Stock Exchange in the past 18 months of non-equivalence no different than before July 2019. Having ensured a seamless transition of trading volumes onto our market in July 2019 and while faultlessly handling unprecedented volumes in March 2020, we have continued to invest in our platform and functionalities to meet the needs of our market participants and keep pace with market trends.

Increasing the Attractiveness of the Swiss Stock Exchange

In 2020, we have rolled out a Trading-At-Last (TAL) session that allows participants to exchange orders at the closing price, and we are also about to launch an alternative ETF Quote-On-Demand market model which resembles RFQ workflow and offers participants an alternative to the existing on book liquidity. Furthermore, we have started our work on Conditional LIS order functionality for SwissAtMid, which will enhance the ability for our members to source block liquidity and is planned for go-live in 2021. We have also introduced some amendments and promotions on trading tariffs over the past 18 months designed to generate some trading cost efficiencies for our members.

Last but not least, we will reactive our Swiss EBBO service once competition resumes, offering trading participants looking for best execution a unique and innovative way to trade Swiss shares. With a single order, they can access three liquidity pools: The Central Limit Order Book (CLOB), our Dark Pool SwissAtMid and Swiss EBBO. The simultaneous execution across the three distinct order books maximizes the liquidity capture and ensures participants are always obtaining the best available price on the Swiss Stock Exchange for their limit order.

Unique Circumstances Allow Unique Insights

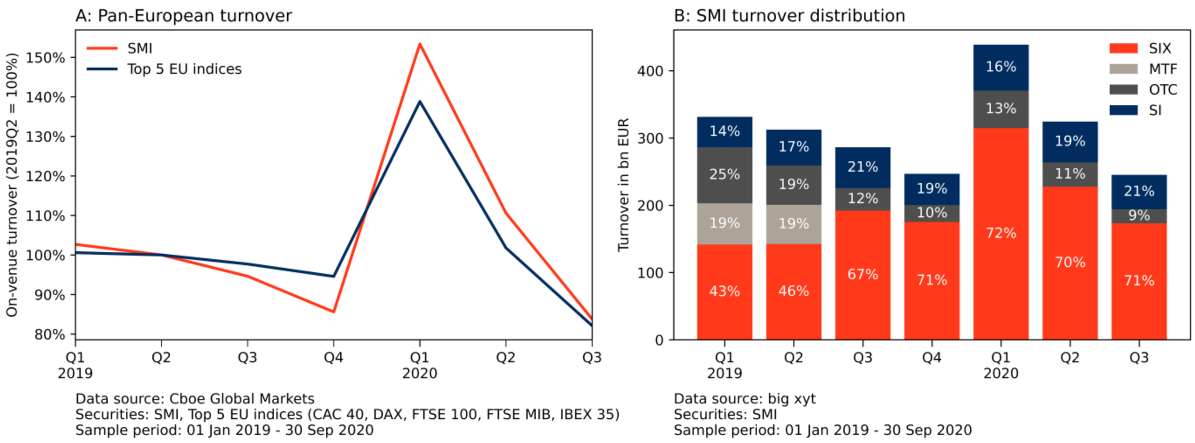
The extraordinary circumstances caused by “Non-equivalence” and the Covid 19-induced volatility shock(s) offer a unique opportunity to investigate the impact of liquidity consolidation on the market quality, a topic which will undoubtedly be a focus for many researchers and practitioners. Against that background, we would like to share with you some of our initial findings in the key areas of impact such as trading activity, order book liquidity and price performance.

a. Neutral to Positive Impact of Flow Consolidation on Trading Turnover

The first panel below concentrates on the trading activity. Chart A compares the SMI on-venue turnover pre- and post- equivalence with the average on-venue turnover across top five EU indices. We normalize Q2 2019 to 100 and plot the turnover deviations. There are clear co-movements across markets as the trading activity fluctuates with market news and volatility. However, most importantly there is no impact of liquidity consolidation on the overall trading activity as we cannot observe any deviations in trading activity – **specifically the loss of multiple venues has not lead to a decrease in the total turnover in Swiss Equities**.

Further, as demonstrated by Chart B, with the loss of equivalence in Q3 2019 the on-venue MTF turnover migrates in its entirety to lit and non-displayed books of the Swiss Stock Exchange. **There is little to no impact on the amount of business conducted on Systematic Internalizers when the MTFs stopped operating in Swiss equities.** The marginal growth we can see is in line with the moderate growth of ELP SI liquidity across European markets.

Figure 1: Turnover in Swiss Equities Pre- and Post- Non-equivalence



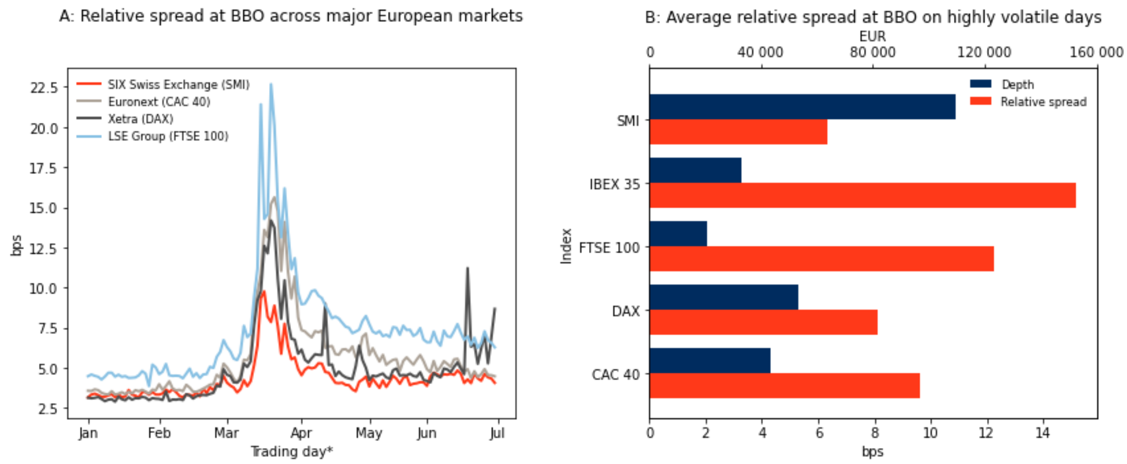
b. Resilience to Volatility Shocks in Case of Fragmented and Consolidated Liquidity

The impact of consolidation on order book liquidity is another pivotal point. **We have seen that spreads on the Swiss Stock Exchange were largely unaffected and depth of liquidity has improved last year as a result of consolidation.** The Coronavirus pandemic presents a unique event to test the impact of unprecedented volatility levels on the liquidity in Swiss equities and contrast it with other European stocks traded on fragmented markets. For that purpose, we plotted the relative spreads for Blue Chip stocks across top European Exchanges in Chart A in figure 2 below.

We observe that relative spreads widened on all primary exchanges but to varying degrees - spreads on the Swiss Stock Exchange remained the tightest and recovered most quickly, whilst spreads on the LSE were the most impacted and have not returned to the levels observed at the beginning of the year. There are a number of factors that could have resulted in diverging spread impact. Some of them include the quality of matching technology, short-selling bans or the structure of the liquidity provider schemes. However, we believe that such a dichotomy between the Swiss Stock Exchange and the rest of the pack points in a direction of consolidated liquidity.

This is a testimony that consolidated liquidity is more resilient to volatility shocks – something particularly important when evaluating implicit trading costs. A 5 to 10 basis points difference between spreads for European Blue Chips (in the same liquidity bands) in March 2020 is significant, especially in high velocity market conditions where investors are making trading decisions with very high execution urgency. That picture is complemented by chart B, which looks exclusively at the most volatile days of H1 2020. The chart emphasizes this message by showing the depth of liquidity at best bid/ask in SMI stocks was more than 100% greater than the depth for other European exchanges.

Figure 2: Relative Spread and BBO Depth across Across Major European Markets



Data sources: BMLL, SIX | Securities: Index constituents | Venues: Primary exchanges
Sample period: 03 Jan 2020 - 30 Jun 2020 | Sampling frequency: 1 day
* Month on axis denotes first business day of the month

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Sample period: Jan 2020 - Jun 2020 | Sampling frequency: 1 day

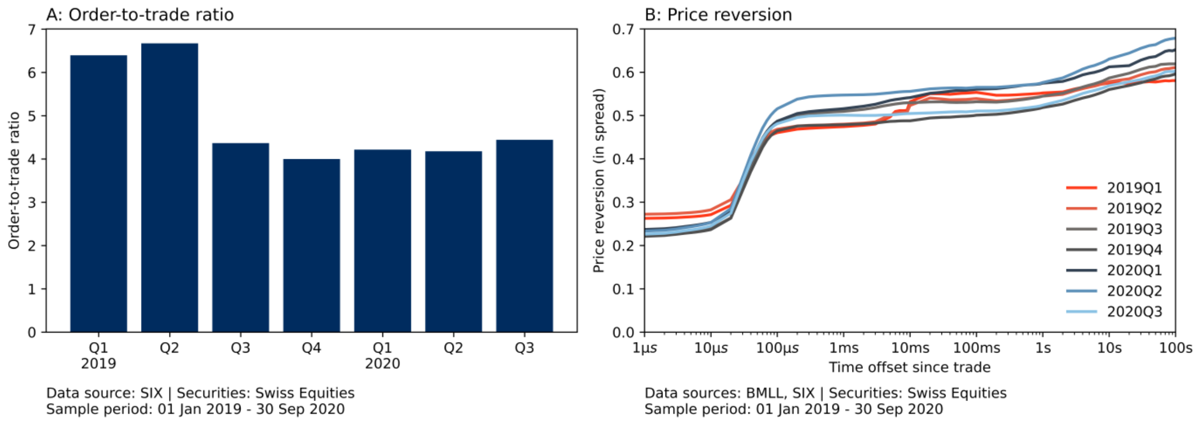
c. Increased Trading Efficiency and No Increase in Toxicity

The final panel looks at two separate metrics: order-to-trade ratio (OTR) in Figure 3 chart A and price reversion in chart B. With MiFID 2 and the RTS 9, venues are obliged to monitor OTR for each trading participant and have appropriate limitations to ensure orderly trading conditions. **As a result of non-equivalence, the OTR values on the Swiss Stock Exchange reduced from above 6 to below 4.** This is a somewhat expected development – with the reduction in the number of venues, there is less cross venue order management and hence order adjustment noise. With the OTR declining by 50%, we observe the persistence of orders increasing and execution efficiency improving as a result.

Chart 2 below monitors changes in price reversion on the lit book of the Swiss Stock Exchange. Price reversion measures midpoint movements following a trade. On the horizontal axis it looks at the time after the trade whilst on the vertical axis it plots the midpoint change in relation to the spread value. Hence, a value of 0.3 indicates a price movement equal to 30% of the spread value at the time of the trade. We observe no significant changes to price reversion on the Swiss market as a result of liquidity consolidation. In fact, the immediate price reversion up to 20 microseconds after the trade is strictly better since H2 2019. When looking at beyond the 20 microseconds period, Q2 2020 is the worst but that is driven by the market conditions, whereas Q3 2020 shows already a marginally better reversion than Q1 and Q2 2019**.**

The conclusion is that price reversion is largely in-line before and after non-equivalence and we can dispel arguments that liquidity consolidation increased toxicity in the order books of the Swiss Stock Exchange.

Figure 3: Order-to-trade Ratio and Price Reversion for Swiss Equities



d. Our First Findings on Consolidated Liquidity in a Nutshell

To recap, we find that the amount of trading activity for Swiss stocks is not impacted by market fragmentations, volumes remain sticky on the trading venue whilst there is little evidence of activity migration into SI or OTC space. Furthermore, we learn that the implicit costs of trading were positively affected by consolidation, in particular during the most volatile market conditions. Last but not least, we observe positive changes to market structure and order book dynamics as suggested by OTR (which is indicative of less noise and more persistent liquidity) but see very little impact on price performance.

Embracing the Debate to Shape the Future of Financial Markets

Undeniably there has been an influx of new market models and venues in Europe in the past few years. There is no doubt that an appropriate level of competition drives innovation and delivers price tension back to market participants. However, it is an inescapable conclusion that ad infinitum fragmentation of liquidity must, at a certain threshold, add more complexity to markets, increase search costs and lead to inefficient replication of infrastructure and operational resources.

As a leading European Exchange, we will continue adapting to market needs by offering solutions that serve our clients but note that we are approaching a tipping point where complexity may soon start outweighing the benefits of competition. Therefore, we embrace debate on market structure that includes the perspective of all market participants, including the buy side, mid-tier and smaller market participants.

As for the outlook for Swiss equities, when equivalence is re-instated, we expect the market to find its balance between the liquidity on the primary and alternative platforms. We are confident that our lit and non-displayed books will remain the most attractive choices for market participants and we are working with the industry to further enhance our proposition. Therefore, I stand optimistic for the future developments in Swiss and European equities for the years ahead.

Author

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Christian Reuss is Head SIX Swiss Exchange and a member of the management committee of the business unit Securities & Exchanges at SIX. Earlier roles at SIX include Head Cash Markets Swiss Stock Exchange and Head Department Sales & Product Management (including Marketing) for SIX Swiss Exchange. From June 2009 until June 2013, he was CEO of Scoach (by SIX and Deutsche Börse). From 2002 to 2009 Christian Reuss worked in several locations for Goldman Sachs, ultimately as Executive Director with pan-European responsibility in the Private Investor Products Group. Christian Reuss has a degree in business administration from Frankfurt's Johann Wolfgang Goethe University and another Master of Business Administration from the Henry B. Tippie School of Management at the University of Iowa. He is a CFA charterholder and completed Executive Management Programs at Harvard Business School and at the IMD.

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