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# Market Structure

Bringing SME back into Capital Markets - Solving the SME conundrum

# Part Three: Rethinking trading for SMEs

May 18, 2021

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Policy makers perceive it is a lack of research that limits investment in SMEs, but for many asset managers it is the lack of secondary market liquidity that is the problem.

In this four-part series, *Solving the SME Conundrum*, we look at the challenges facing SMEs and their access to capital markets. In Part One we looked at the importance of IPOs in the SME eco-structure; in Part Two we explored the potential outcome of rebundling research and its subsequent impact on SMEs; in this third paper we focus on the need to improve secondary market liquidity as a means of boosting investment in SMEs.

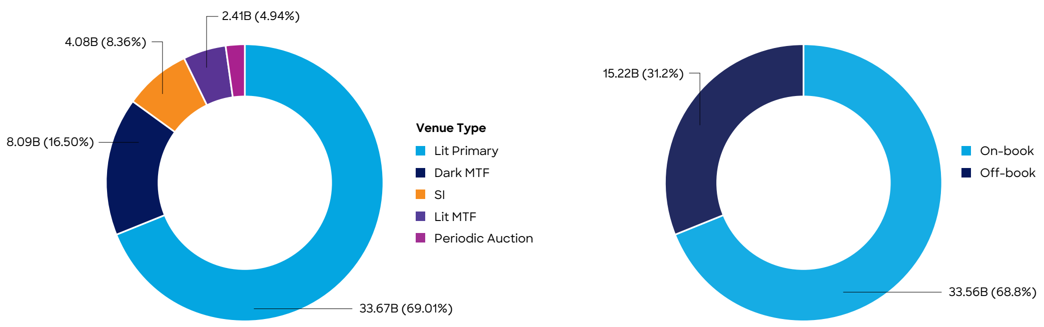
Any successful investment requires the ability to exit as well as instigate a strategy. Daily fund liquidity rules alongside recent secondary market activity post the pandemic makes it harder for risk committees to justify investment in illiquid instruments, precisely at the point when policymakers want to encourage greater investment in SMEs. Risk is accentuated in SME names when the liquidity available is often cyclical, particularly around earnings events, limiting the appeal for mandates to include investment in SMEs. The recent high-profile Woodford scandal[1] and the subsequent increased regulatory focus on managing liquidity stress within portfolios and reporting requirements only amplifies this.[2]

While there is consensus that MiFID has improved the liquidity of blue-chip stocks, there is less evidence that smaller cap companies had the same experience. MiFID II created a new category of MTFs labelled SME Growth Markets (SME GMs) aimed at facilitating the listing and trading of SMEs. To date, 20 MTFs have been granted the status of SME GM, while 15 additional MTFs target the financing of SMEs but decided not to apply for the SME GM regime.[3] In its review of the newly created regime, ESMA noted that total trading volume in SME shares on MTFs amounted to €2B[4] at the end of 2019 and is looking at means to further develop this European setup. However, according to the European Commission, trading volumes of SMEs are not sufficiently material to make them attractive for new lower cost 'MTFs' or electronic liquidity providers (ELPs). The assumption is that the bulk of SME trading is carried out on lit primary exchanges. Yet, it is not where SMEs are traded but how they are traded that warrants attention. Although lit primaries represent 69% of activity, dark MTFs 17%, SIs 8%, and lit MTFs 5%, for those trades reported on-exchange 31% are tagged as off-exchange, meaning SME trades are being facilitated off-book and then printed on-venue, rather than trading in lit continuous markets (*see Exhibits 1 and 2*).

> "I don't trade SME stocks when I want to, I trade them when and where I can."
>
> **Head of Trading**
> UK Medium-sized Asset Manager

### Exhibits 1 and 2

**European and UK small-cap market makeup**
**European and UK small-cap primary on-book/off-book**




*Source: Bloomberg data as of April 2021*

> "Daily liquidity just isn't suitable; you need a notice period of a year to give time to the fund manager to reallocate with SMEs. Look at the sharp correction post-Lockdown 1– even if you had wanted to sell, you couldn't, there was no one on the other side. Then, as a fund manager you are faced with a wall of reporting, and so when it comes to looking again at investing in a small-cap you are going to think again because no one wants to go through the nightmare of reporting every time something goes wrong."
>
> **Portfolio Manager**
> UK Medium-sized Asset Manager

## Upskilling Facilitation

Traditionally, trading SMEs relied on uncovering available liquidity off-exchange; the means of facilitating this liquidity now needs to be upgraded for 21st century trading. Recent trading activity since the start of the pandemic has demonstrated the importance of being able to put trades together efficiently in fast moving markets when large sections of the market are increasingly dependent on automated workflows, rather than voice trading.

For an investment in a stock with an order size that is 250% of the average daily volume (ADV), understanding the liquidity events around earnings is not enough. The data that can be incorporated into the execution process may include unstructured content such as machine-read corporate communications and social media as well as broader structured data—short interest, directors' dealings, volatility, credit indicators, and market events. There is no concept of a global exchange and downloading regulatory filings is a nigh on impossible

*1 https://www.bbc.co.uk/news/business-48510235*
*2 https://www.esma.europa.eu/press-news/esma-news/esma-strengthens-liquidity-stress-tests-investment-funds*
*3, 4 https://www.esma.europa.eu/sites/default/files/library/final_report_on_sme_gms_-_mifid_ii.pdf*



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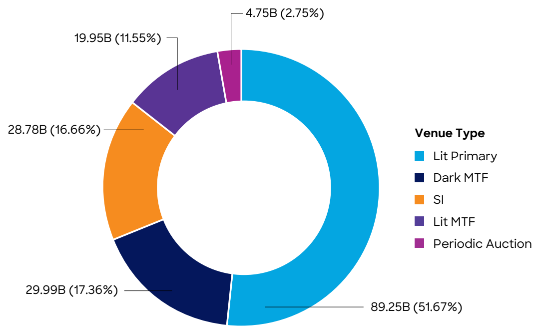
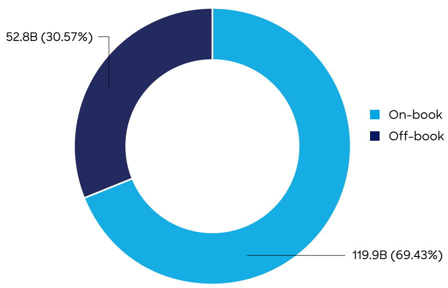
task. Full visibility of trading activity—lit and dark—is required as well as the peripheral factors around that liquidity to build a more holistic picture of how secondary market activity occurs and how it can be generated. The current discrepancy between volumes reported as traded on-exchange and where the real liquidity is pooling can mislead market participants about who the main providers of liquidity are, which is exacerbated by the absence of a consolidated tape in Europe. To represent liquidity calculations fairly, all market activity should be incorporated, lit and dark, which in turn would increase investors' confidence to invest in SMEs.

If we conduct the same analysis for mid- and large-caps, while off-book volumes remain relatively stable as a proportion of lit primary trading, approximatively 30%, SI activity tends to increase as we go up the market cap spectrum, highlighting that it is more profitable for a bank to cover a large-cap as it will be rewarded with volume as opposed to a small-cap (see *Exhibits 3 and 4*).

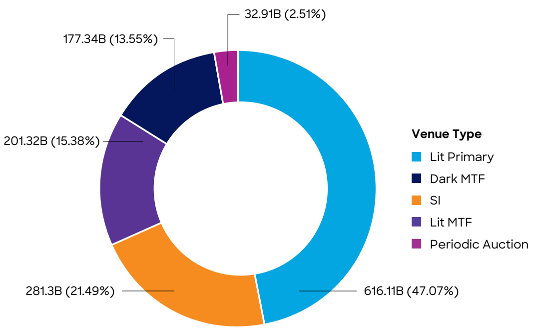
### Exhibit 3
**European and UK mid-cap market makeup**
**European and UK mid-cap primary on-book/off-book**

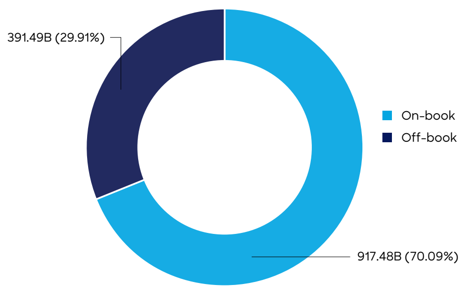



*Source: Bloomberg data as of April 2021*

### Exhibit 4
**European and UK large-cap market makeup**
**European and UK large-cap primary on-book/off-book**



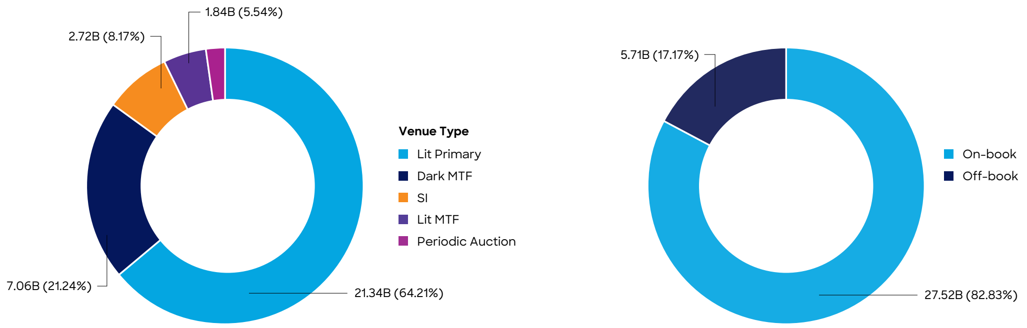

*Source: Bloomberg data as of April 2021*

Liquidity formation in small-caps differs between Europe and the UK. European activity is based on agency activity, relying on the lit primary and dark trading to execute small-cap names, representing 64% and 21% respectively, with only 17% of activity off-exchange (*see Exhibit 5*). UK activity is focussed more on the use of risk, relying more on off-exchange activity, representing around 33% of volumes printed on-exchange (*see Exhibit 6*).

Executing a small cap on the lit market is often onerous if not an impossible task, taking months sometimes to find a counterpart to trade with, and even then the price can quickly be negatively impacted given the sensitivity of any information leakage. Aware of the challenge in trading SMEs, exchanges are also looking to reinvent their offerings through use of smarter IOIs to target specialist brokers. A broker wanting to buy a French small cap would be able to route the order on behalf of the asset manager, targeting French SME specialists, thereby providing the members with additional execution options and leveraging the exchange's connections in local markets. Specialist brokers view this as an alternative to the bulge brackets which tend to absorb flow from SME specialists as their own, depriving specialist brokers of the opportunity to advertise their flow.

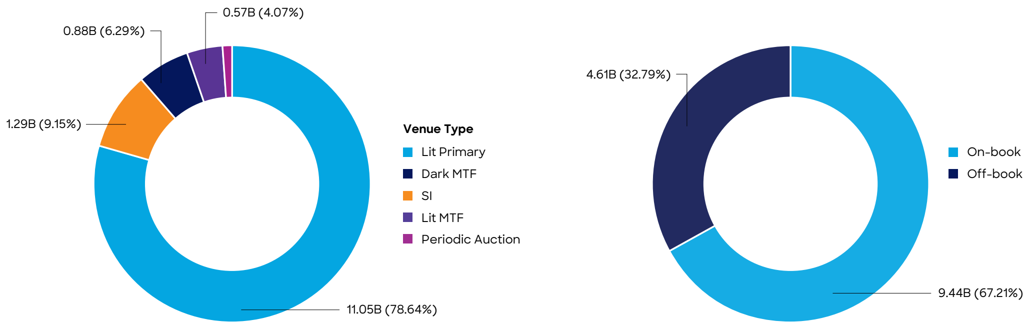
In the absence of available liquidity, specialist brokers are able to gauge legitimate interest and at what price. Trust is essential but trading can often be manual, take place over several days, and be subject to flaws in execution performance—one side being preferred over another depending on their level of urgency to trade. The trade also sits with the specialist, limiting access to quantitative data to model, which prevents certain market participants—such as quant funds—from participating.

**Exhibit 5**
**European small-cap market makeup**
**European small-cap primary on-book/off-book**




*Source: Bloomberg data*

**Exhibit 6**
**UK small-cap market makeup**
**UK small-cap primary on-book/off-book**




*Source: Bloomberg data*

## From the Specialist to Specialist Technology

The role of data and technology is becoming increasingly important in enhancing the buy side's ability to increase its liquidity options via automated workflow processes, and thereby the execution performance. While the ability to use data efficiently in execution has always mattered, the increase in liquidity fragmentation requires firms to rethink how data could be incorporated into the decision-making process. In recent years new tools such as Targeted Invitations and PM watchlists have evolved the use of analytics in establishing where liquidity in an instrument is pooling or when an issue was last traded to maximise the available alpha opportunities as well as ensure the delivery of best execution.

While efforts to increase investments in SMEs have traditionally focused on research coverage, increased regulatory pressure on funds to ensure adequate liquidity levels has acted as a deterrent to investing in SMEs. European markets are not as deep as the US. The need to improve liquidity access by honing in on data and technology capabilities to understand when, where, and how to trade an instrument based on its liquidity profile is increasing in significance. As ESG moves mainstream, the pool of investable assets will continue to decrease, reinforcing the squeeze in the near term unless alternative access to liquidity can be found.

For this, in the final of this four-part series, we will explore the rise of retail activity as a potential means of addressing the declining secondary market liquidity of SMEs.

**If you have any questions or if you would like more information on Liquidnet Investment Analytics, please contact:**

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