acuiti management intelligence

Proprietary Trading Management Insight Report

Q1 2023

Produced in association with

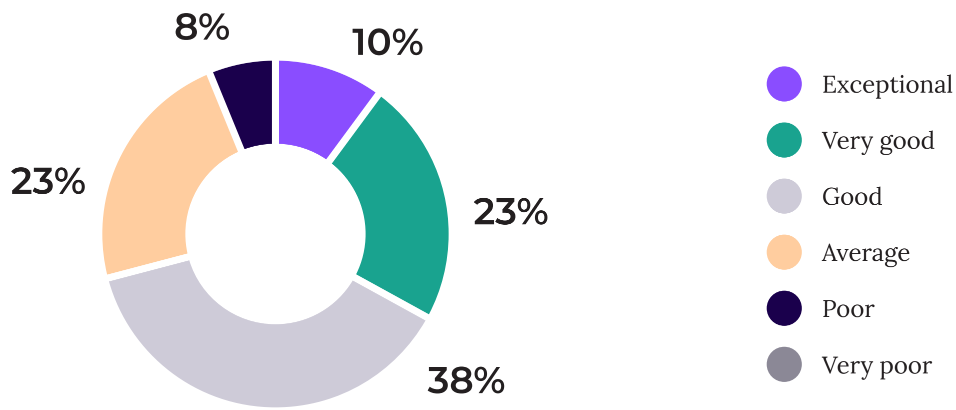
AVELACOM

Table of Contents

Looking back at 2022 and ahead to 2023

Last year was in the main a very good year for proprietary trading firms, as the volatility that gripped global markets led to increased volumes and opportunity. Almost 70% of the Acuiti Proprietary Trading Expert Network, a group of over 100 senior executives in the global market that receive the quarterly survey on which this report is based, reported better than average annual profitability in 2022. This has led to a generally bullish outlook for the beginning of 2023 (see sentiment index in Section 7) and network members seeing opportunity in most asset classes, including cryptocurrency.

In terms of profitability, how strong a year was 2022 for your business compared to an average year?



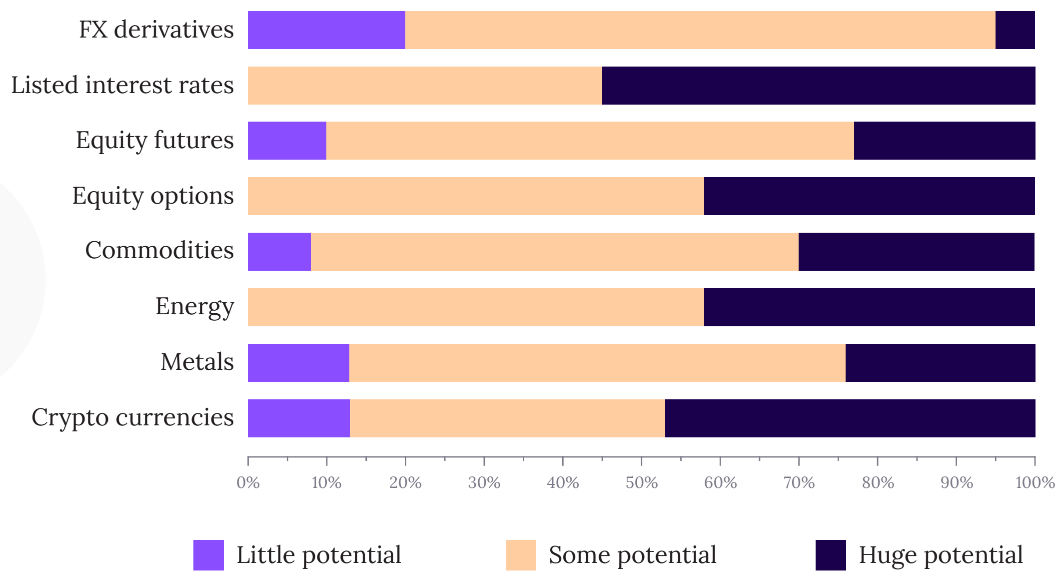
The industry isn't without its headwinds though. For those involved in cryptocurrency trading, the fallout from FTX's bankruptcy is still being assessed (see page 9). Of the firms that reported a poor performance in 2022, two thirds traded crypto. Energy was the best performing asset class with all firms reporting an exceptional year trading it as part of their portfolios.

Despite expectations of a strong year in 2023, challenges remain. Liquidity remains an issue across global markets and in particular in Europe. How best to improve that remains a source of continued debate that we address in this quarter's report, including an evaluation of how passive liquidity programmes have performed since their introduction.

Where is the opportunity in 2023

Looking ahead to this year, the network saw potential in most asset classes. Listed interest rate contracts and equity options were seen to have significant potential, with volatility in both underlying markets set to continue through this year as rates markets adjust to central bank policy tightening and equity markets feel the knock-on effects of an economic slowdown and the more restrictive financing environment that those market conditions are creating. This was a similar situation to last year, when both asset classes were seen as having significant potential by the network. This year though, optimism is higher for rates contracts than equity options, a swap on last year.

How do you expect the asset classes that your organisation trades to perform in 2023 in terms of the potential for profitability in your business?



Commodities were also still seen as an area with significant potential for profits and the network is more bullish on the asset class than last year, when it was seen as one of the few potential safe havens in an inflationary and volatile market environment

Despite the scandals and failures of last year, the network's sentiment towards cryptocurrencies was surprisingly robust. This perhaps reflects recent revivals in the price of bitcoin but is testament to the digital asset market's capacity for survival despite the crypto winter and the FTX bankruptcy (see page 10).

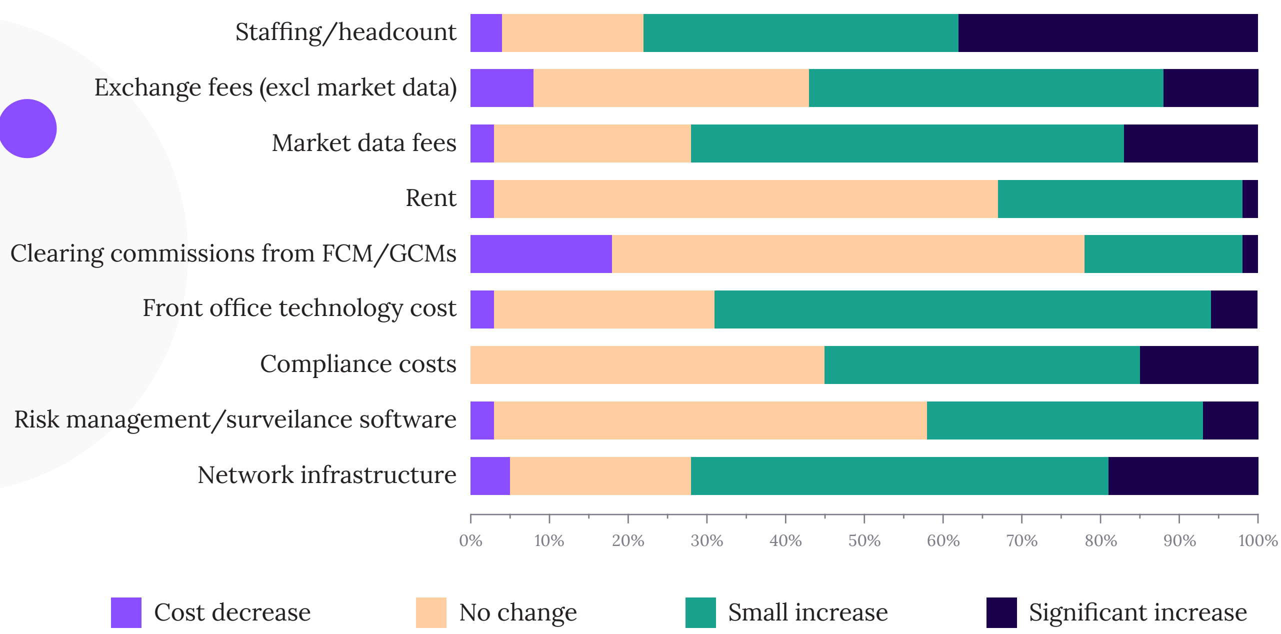
Last year, 52% of the network saw huge potential in the asset class and 43% some potential. This year, the mood had cooled but not to a level that suggests firms are abandoning the market en masse.

Where did costs grow most in 2022?

When assessing the costs of last year, the network reported the most significant increases coming from staffing and headcount. Finding and hiring talent has been a problem for many corners of the financial industry and prop trading has been no exception. A common complaint has been the difficulty of locating young talent in particular, given competition from other sectors like tech.

Compliance was also another source of growing costs, as was network infrastructure. Network members also reported increases in the cost of their tech stacks, with front office technology and risk management and surveillance software expenses rising in 2022. Market data fees also continued to put pressure on budgets. One area where almost one-fifth of the network did report a fall in costs was clearing commissions.

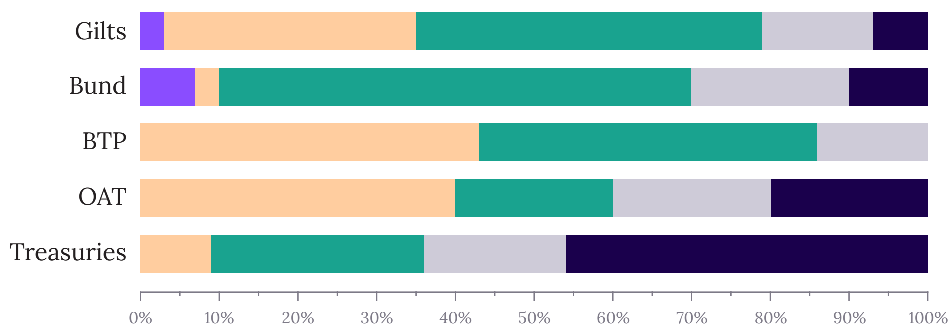
How did your cost base change in the following areas in 2022?



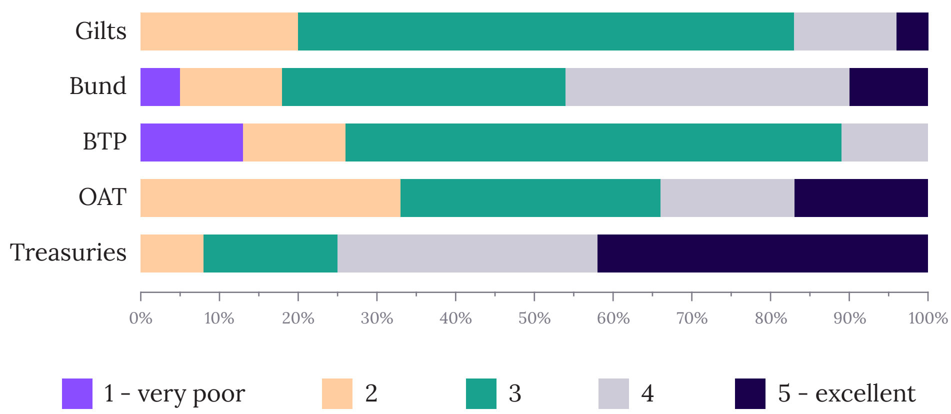
Assessing rates liquidity

In the first of a running series, we are asking network members' views on the state of liquidity in the on-screen contracts that they trade. First up in this quarter's report are rates contracts. Acuiti asked its network to rate the liquidity of the rates contracts during open, close and intraday. Treasuries were seen as having superior liquidity at all stages of the trading day. Indeed, they were the only contract to win a positive assessment from more than half of respondents at each of the three stages of the day.

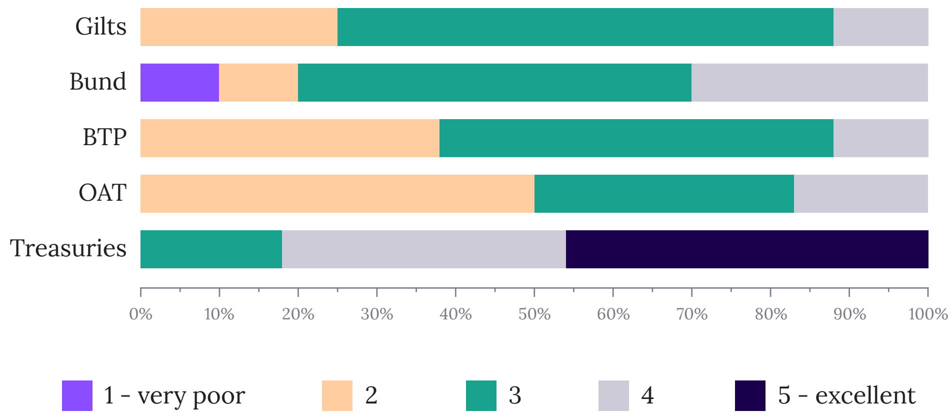
Overall, how would you rate the liquidity in the contracts you trade at market open?



And how would you rate the liquidity in the contracts you trade intraday?



How would you rate the liquidity in the contracts you trade at the close?



The network did not paint as positive a picture of liquidity in European rates markets, however. While Bund contracts were seen to have reasonably good liquidity at the open and (less so) the close, intraday liquidity in these markets was reported to be challenged.

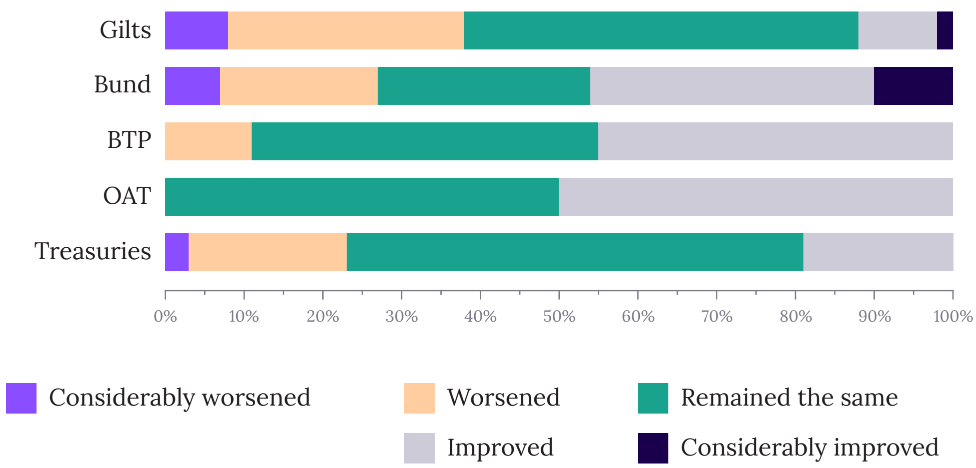
Liquidity was seen to have deteriorated most in Gilts contracts, with 38% of respondents noting this trend. This can be most obviously attributed to the chaos caused by the UK's mini-budget debacle and the knock-on crisis that it caused for UK LDI pension strategies and the Gilt markets that they rely on.

However, there are more serious structural concerns in the sterling options markets as the number of market makers has reduced significantly over the past decade.

While this was by far the most dramatic example of bond market illiquidity since markets entered a rising rates cycle, the issue has dogged most govvie-referencing contracts.

A significant amount of members reported worsening liquidity in Bund markets. OAT and BTP referencing contracts were seen to have worsened the least, although the overall liquidity profile of each market was not depicted in a particularly favourable light (see charts above). Despite Treasuries being considered the most liquid contracts, more members saw a deteriorating liquidity profile in these markets too.

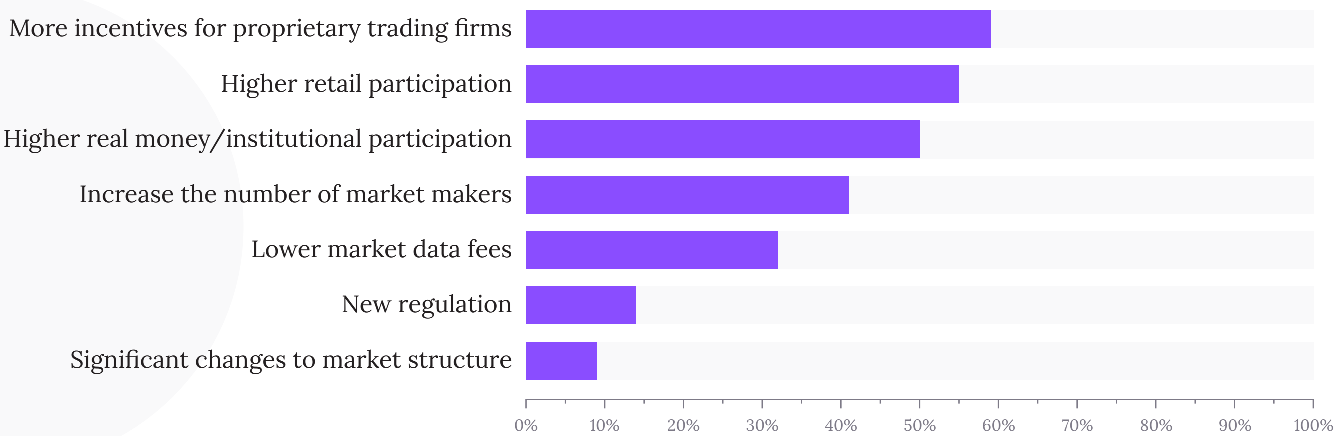
Over the past 12 months how has liquidity changed in the contracts you trade?



Answering the liquidity conundrum

Worsening liquidity across asset classes has had a negative effect on many prop firms, with network members reporting that they were trading lower volumes and smaller tickets, as well as making less money from their rates trading businesses. Some firms reported trading in new markets and instruments as a way to boost margins. How to reverse this trend is a subject of much debate in the community. Most (inevitably perhaps) favoured increasing incentives for prop trading firms as a tool for improving on-screen liquidity and volumes. Higher retail and institutional participation were also popular measures for improving the situation. Respondents in the US also suggested a complete ban on payment for order flow as a measure for improving liquidity.

Overall, what do you think can be done to improve on-screen liquidity and volumes?



Hot Topics

Life after FTX

Recent years have seen more prop firms moving into cryptocurrency trading to capture the higher volatility in that market compared with traditional asset classes.

That optimism was upended with the bankruptcy of FTX in the wake of fraud allegations. The main impact of this shock event among those firms that did make the jump into crypto has been a reduction in overall exposure to the asset class.

Heightened consciousness around exchange risk has also been a notable result. It was common for firms to report reducing the number of exchanges that they trade on. Some network members also reported adding exchange default insurance to their costs.

Others reported reducing the margin deposits that they held at exchanges to a minimum and using leverage compensated by cash at the bank to remove the leverage they held in the market.

It will be interesting to see whether this trend leads to greater monopoly power for some of the remaining exchanges, the growth of an OTC cryptocurrency market or a shift towards regulated markets.

A noteworthy number reported that they wouldn't be changing their approach to the asset class though. The durability of institutional faith in the product is an interesting trend that Acuiti has consistently picked up in research following the aftermath of large and negative events in the market.

After both the beginning of the crypto winter, the collpase of Luna and now the FTX scandal, a significant amount of institutions in the market have kept the faith in cryptocurrencies.

Assessing PLP

Passive liquidity protection, or speed bumps designed to reduced the advantage that low latency trading firms can achieve, caused much controversy when introduced by exchanges, with many high frequency trading firms up in arms about the schemes and the perceived threat they posed to their ability to compete.

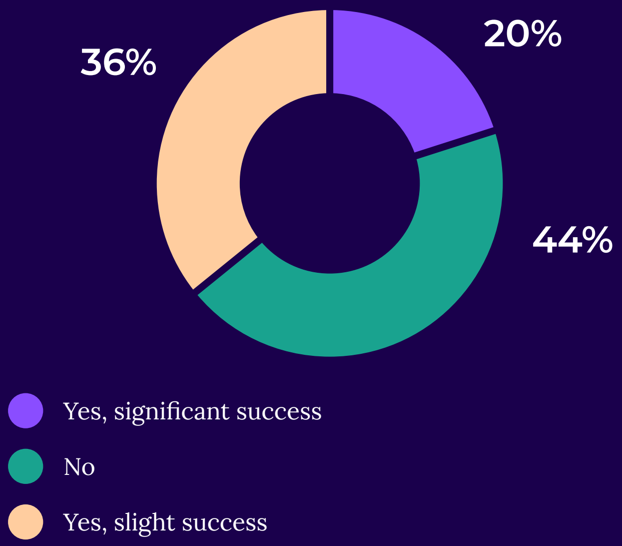
But over time, exchanges such as Eurex have won plaudits in the prop trading community for the improved liquidity picture that these reforms have created.

Overall, the majority of the network believed that speed bumps have been a success at exchanges, although most of the respondents said that they had only been a slight success.

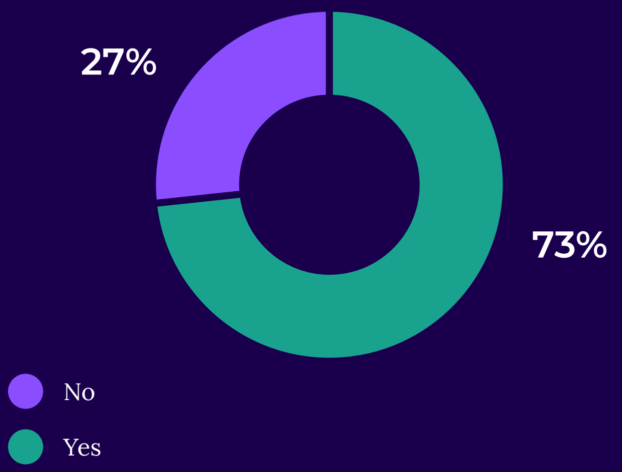
It is clear that introducing speed bumps by themselves is not a guarantee of their success. Exchanges have to get the parameters of speed bumps right for them to work, not always punishing speed, for example. Eurex's introduction of PLP for Euro Stoxx 50 contracts was cited as one example of a successful implementation that had improved price competition and flow in the market.

A large majority of the network believe that PLPs should now be rolled out at more exchanges, where they could provide a needed boost to the liquidity profile of contracts that are currently less traded.

Have passive liquidity protection programmes at exchanges been a success to date?



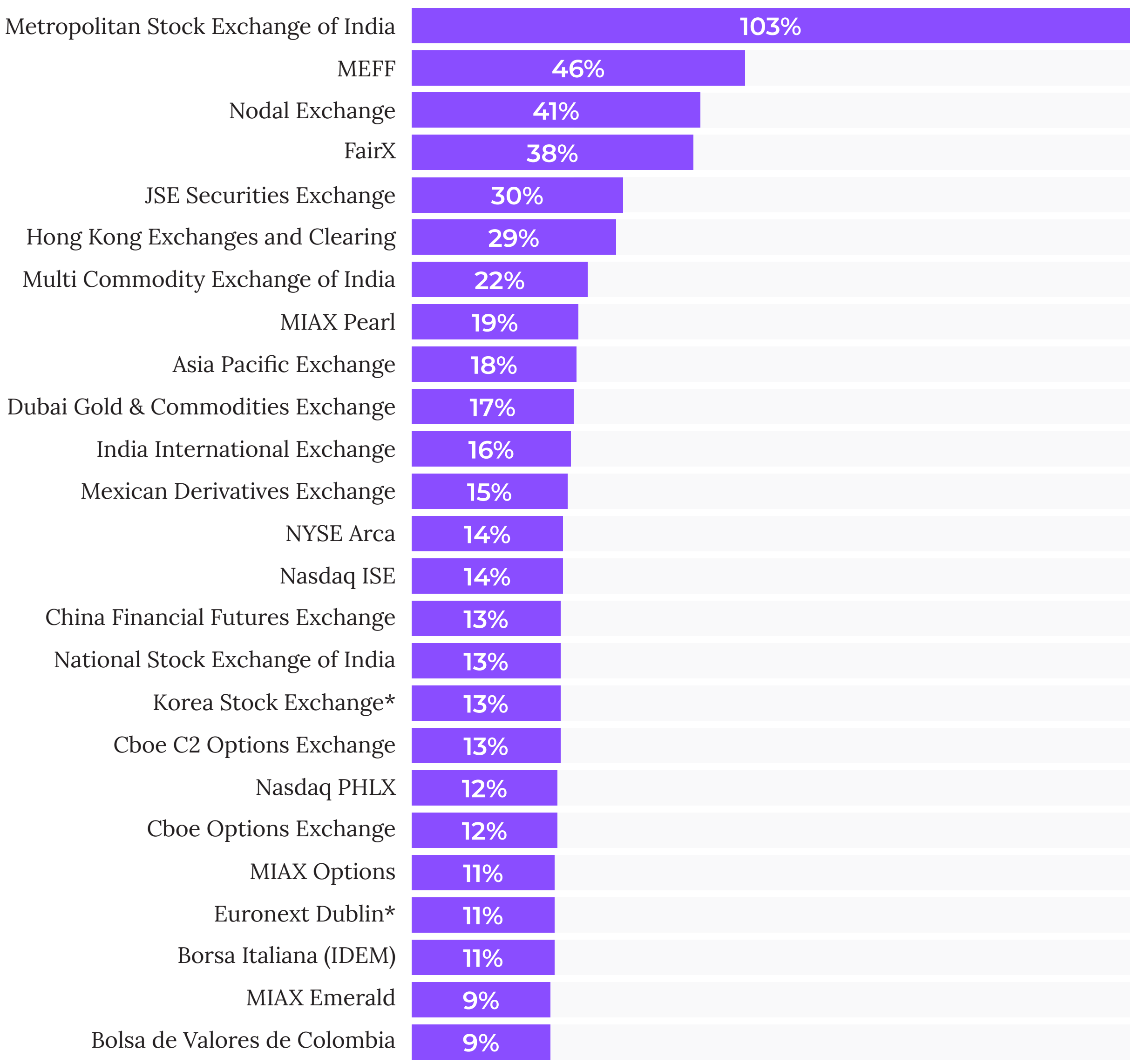
Should passive liquidity protection programmes be rolled out at more exchanges?



Exchange growth and new contracts

The Avelacom Exchange Growth Index

The Avelacom Exchange Growth Index is a benchmark of quarter-on-quarter volume growth across cash equities and derivatives markets. Exchanges must have been trading for more than one year to feature in the index. Futures and options data is provided by the FIA, cash equities from the exchange websites.



*Cash equities

Source: FIA, Exchange Websites

New contract watch

The table below, based on data provided by Euromoney TRADEDATA, profiles the performance of the top 15 new contracts launched last quarter based on average daily volume.

Exchange	Contract	Type	Volume	Open Interest	ADV	Launch
China Financial Futures Exchange	SSE 50 Index	Option	200,627	26,284	9,119	26-Dec
Shanghai Futures Exchange	Steel Rebar	Option	122,839	32,578	5,583	26-Dec
Shanghai Futures Exchange	Silver	Option	38,963	9,638	1,771	26-Dec
Thailand Futures Exchange	USD/JPY	Future	91,945	3,800	1,532	31-Oct
Thailand Futures Exchange	EUR/USD	Future	39,741	1,064	662	31-Oct
Chicago Mercantile Exchange Inc	Euro Short-Term Rate (Euro STR)	Future	16,779	1,191	262	31-Oct
Hong Kong Exchanges & Clearing	Hang Seng TECH Index OOF	Option	10,641	9,974	168	28-Nov
Eurex	Bloomberg Liquidity Screened Euro High Yield Bond	Future	6,712	5,559	104	17-Oct
Eurex	MSCI World Minimum Volatility	Future	6,689	6,689	104	07-Nov
Singapore Exchange Derivatives Trading	Mysteel Shanghai Rebar (USD)	Future	2,617	542	40	31-Oct
Chicago Mercantile Exchange	Euro Short-Term Rate (Euro STR) Three-Month Single Contract Basis Spread	Future	2,539	639	39	31-Oct
New York Mercantile Exchange	LNG North West Europe Marker (Platts)	Future	305	910	4	24-Oct
Eurex	Micro-MDAX	Option	209	175	4	19-Dec
Bursa Malaysia Derivatives Berhad	FTSE4Good Bursa Malaysia Index	Future	72	8	3	12-Dec
Chicago Mercantile Exchange	USD Denominated TOPIX Index	Future	84	1	1	21-Nov

Source: EuromoneyTRADEDATA

Q&A with Graham Rodford, CEO, Archax

Where are you with the build out of the exchange currently?

The Archax FCA-regulated custody service is live and we are actively marketing this and onboarding clients. Providing an institutional-grade, digital asset custodian, using an insolvency-remote structure where all client assets are held 1-for-1, is proving extremely interesting to people, particularly in a post-FTX crypto world

Our FCA-regulated exchange will be live later this month. We will have one market for regulated digital assets, like tokenised real-estate, equity, debt and funds, and an unregulated market for cryptocurrencies. Like our custody service, our crypto market looks like a traditional market, with all the controls and processes institutions need and expect, so providing trading in unregulated crypto assets for them in a familiar and acceptable way.

What role do you think regulated exchanges will play in the next phase of crypto trading?

With the turbulent times seen in crypto markets recently, it is only a matter of time before regulators around the world tighten their grip on the space and regulate cryptocurrency instruments themselves or activities involving them, or both. I think the crypto community generally welcomes this– and it is essential for mainstream institutions to get involved anyway.

We've always believed that this day would come – maybe a little sooner than originally expected! And we've built Archax to provide regulated exchange, broker and custodian solutions, for all types of digital assets, accordingly. So, with this change coming, regulated markets as well as other services are going to be key for the growth of the crypto space with this new focus from regulators.

Where are you seeing interest from in onboarding to trade crypto?

Right now, we are seeing a lot of interest in our digital asset custody service as people recognise what went wrong at FTX and others, and are now looking for safe, credible alternatives that provide the right level of service in the right way. On the crypto trading side, volumes are clearly down. What we see is that those institutions that were already involved in crypto, are believers and still there – albeit in a rather more conservative and measured way. For those institutions that haven't got involved yet, they seem to be happy to remain on the side-lines right now until some stability returns, and the path forward for the space becomes clearer, particularly from a regulatory standpoint.

You are pioneering the trading of digital securities, what potential do you see here and how will the market develop?

Cryptocurrencies are really just the first use-case for the underlying blockchain/DLT technology and concepts like tokenisation. They have pioneered what can be done and proved the potential way forward for other use cases. Digital Securities is one such use case – leveraging these same concepts to create a new way of recording ownership of an asset and provide investment opportunities in it in a much more democratic and efficient way.

The key difference is digital securities are regulated instruments and trade on regulated markets, so are much more familiar and palatable to financial markets institutions. Examples we see are: people tokenising equity or debt to raise money from new digitally-connected communities; assets like real-estate being opened up to allow direct access for new investors; and tokenised funds, where secondary markets can be created to allow people to trade in tokens outside of normal redemption cycles and create a permanent source of capital for fund managers.

Archax is built on a blockchain platform, what benefits does that bring to market participants and what are the current limitations of the technology?

Archax is actually blockchain agnostic and supports a wide range of leading DLT solutions. Some of the key benefits that the technology brings, include: opening up access to previously hard to trade assets; bringing liquidity to currently illiquid assets; opening up investment opportunities in assets to new investors; creating new innovative digital instruments and structured products; and improving the efficiency of maintaining ownership records of assets and then trading them – particularly in the post-trade space.

One of the key limiting factors for digital securities and the use of blockchain technology to realise its full potential, is regulation – which is currently designed for the legacy solutions that are in place, and so can limit the benefits that could be gained. An example of this is the mandated use of Central Securities Depositaries (such as Clearstream or Euroclear CREST) in the UK/EU to record ownership of any asset that is admitted for trading on a regulated secondary market. As such, for digital securities you end up with two records of ownership – one on-chain and the other in the CSD. This is inefficient and limits many of the other potential benefits of having digital tokens involved. A solution for this is to have a digitally-native, blockchain-based CSD, so that both records of ownership are one and the same. At Archax we have set up a subsidiary – Montis – which is developing just that.

What do you see as the future market structure in a DLT-enabled world?

We believe that all traditional financial markets will move across to leverage blockchain/DLT technology and tokenisation – as it is simply a much better and more efficient way to run markets. One only has to look at what has happened in other industry segments – such as the music industry, for example. We all used to buy vinyl, then cassette tapes, then CDs, then we downloaded music to devices, and now we stream it live without even thinking about it. Music hasn't really changed – apart from genres coming or going in terms of popularity – but the way we consume it and the commercial model involved is completely different. The DLT-enabled financial markets world has the potential to do the same for capital markets.

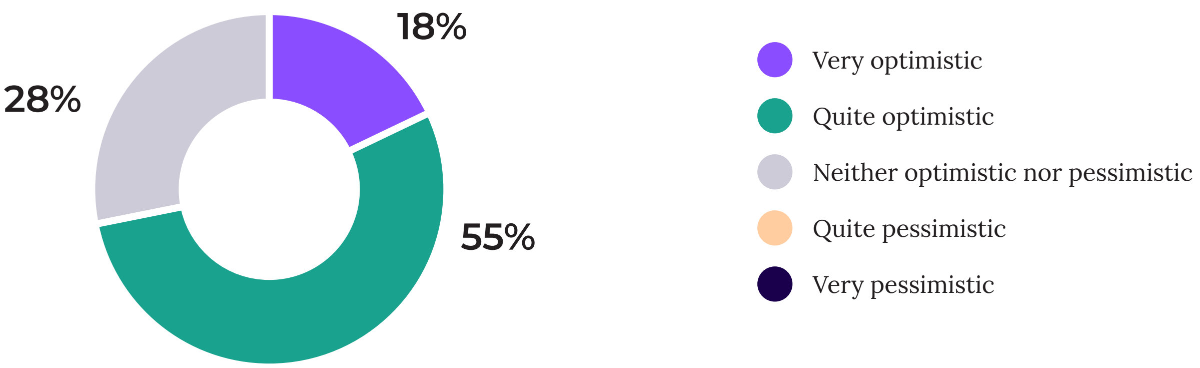
What is next for Archax?

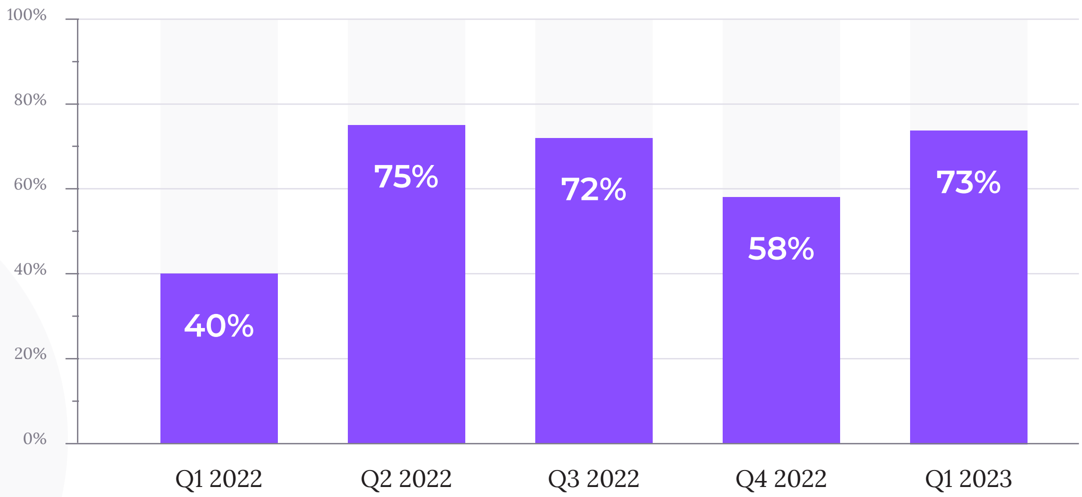
We are now working closely with a number of leading financial institutions looking at leveraging tokenisation to create innovative financial products – such as with abrdn who invested in out Series A raise last year. As well as providing a market for others to list digital asset products, we are also keen to leverage the technology to create interesting, regulated, institutional-grade products of our own. We are also currently working on a range of regulated crypto ETPS (exchange traded products), as well as looking at other regulated security instruments that can give access to ETH staking exposure and Bitcoin mining hashrates. What is happening currently in the DeFi space is really interesting too, and we are looking at ways to leverage the technology and concepts being pioneered there, but in an institutional, regulated way.

The sentiment index

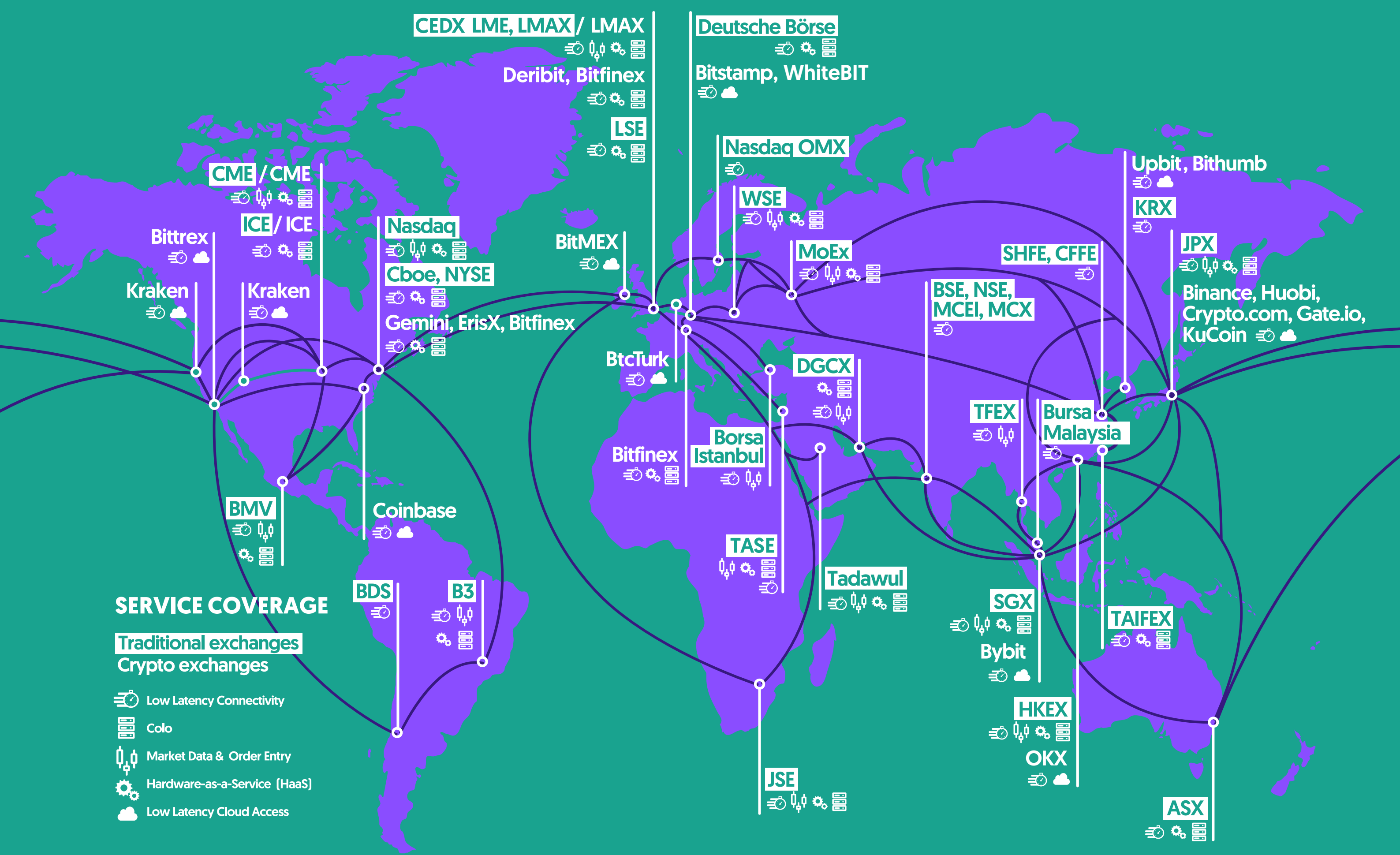
This month's overall reading for the prop sentiment index was 73, with most of the network upbeat over their prospects for profitability in this quarter. Year-on-year that presents a much more upbeat outlook than the 40 score in Q1 2022. It is also the highest quarterly level since that period and a significant rise from the 58 score posted in our last quarterly report and the first ever in which no respondent was pessimistic.

Looking ahead to the next three months, how optimistic are you about the environment for your business performance?





AVELACOM



#1
ULTRA LATENCY INFRASTRUCTURE
FOR MARKET MAKERS AND ARBITRAGE TRADERS

TradFi CeFi DeFi

OUR CLIENTS