acuiti management intelligence

Proprietary Trading Management Insight Report

Q1 2024

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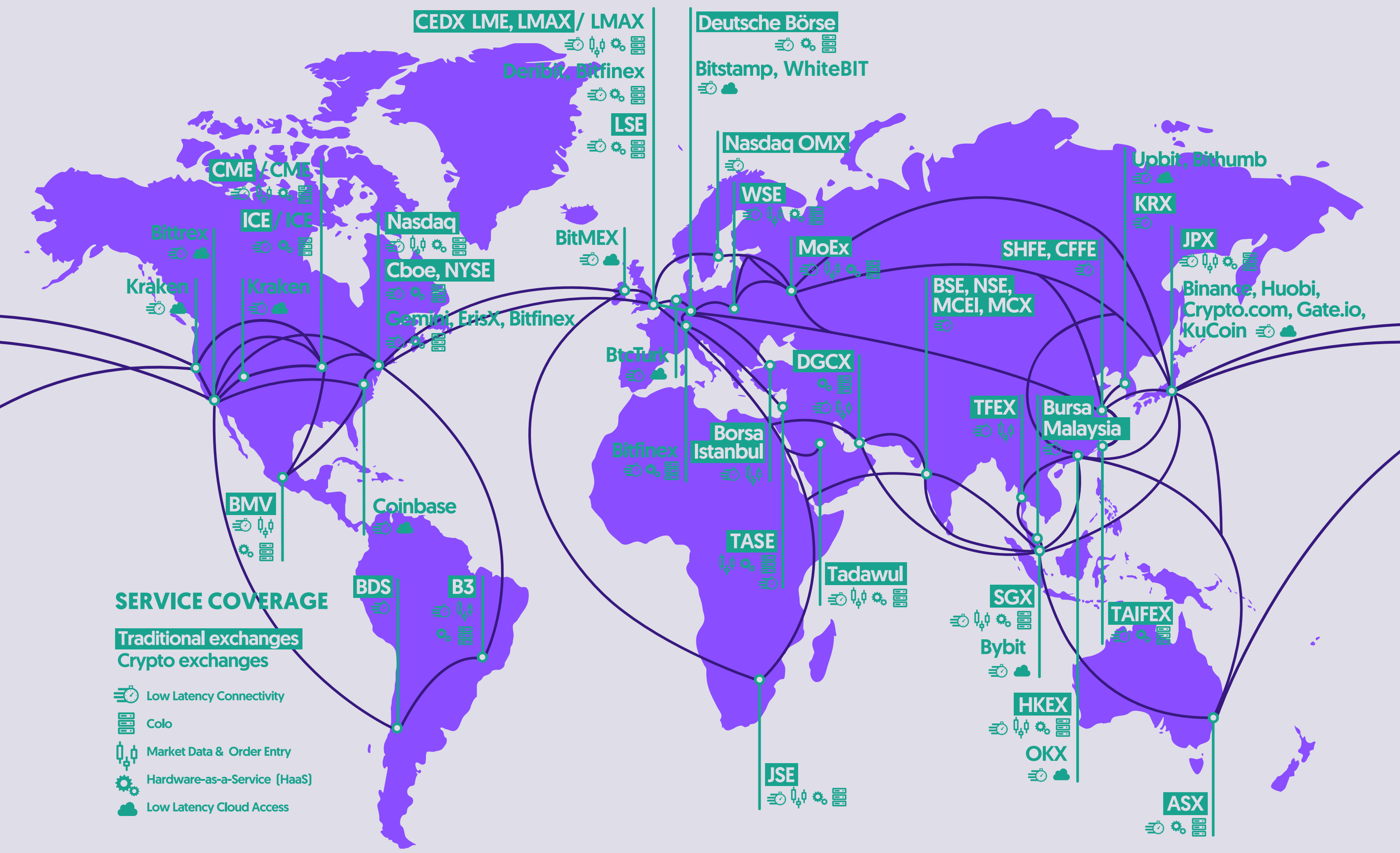

#1 ULTRA LOW LATENCY INFRASTRUCTURE

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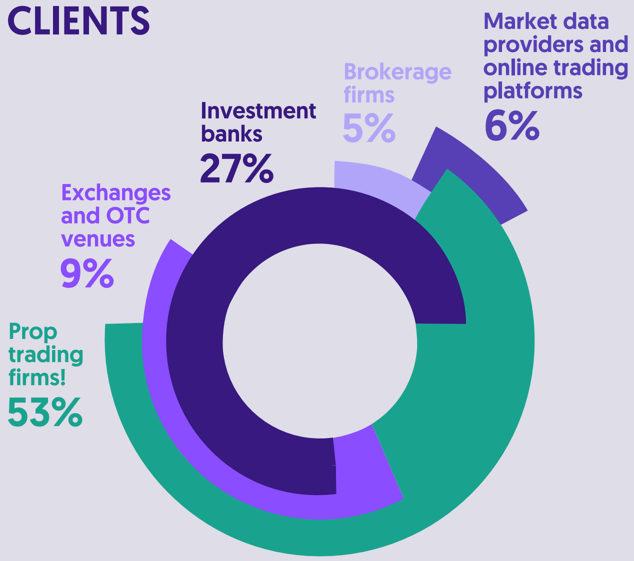

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Introduction

After a challenging 2023, enthusiasm has exploded in the proprietary trading community after a profitable January. Sentiment in the community for the three months ahead, as measured in the Acuiti sentiment index, is as positive as it has even been.

In the first Acuiti Proprietary Trading Expert Network of 2024, we look back on last year, with the annual analysis of profitability and cost bases.

We then take a look at how the regulatory burden facing props differs from region to region and the impact that is having on operations. We also look at the status of clearing provision in the market, and how resilient the prop trading community would be in the face of the exit or failure of a sell-side clearing provider from the market.

We also consider other hot topics facing prop traders — zero-day options, bitcoin ETFs, OTC options markets and expansion into new markets.

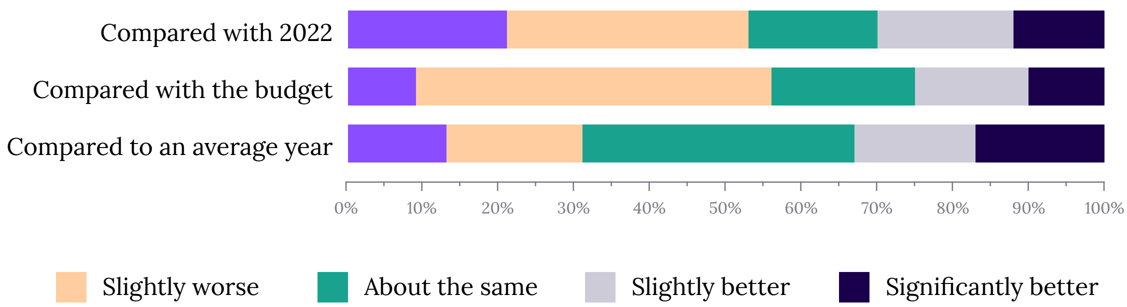
This report is based on a survey of the Acuiti Proprietary Trading Expert Network, a group of over 100 senior executives from across the global community. Each quarter we survey the network on questions suggested by the network and our Steering Committees.

Section 1

Evaluating 2023

Acuiti's first Expert Network Proprietary Trading report of the year starts on a mixed note, as members of the Acuiti Proprietary Trading Expert Network take stock of 2023. After a stellar 2022 for many firms as volatility gripped global markets, 2023 was generally average for proprietary trading firms. For over half of the network, the drop in 2023 was unexpected, with 56% reporting that the year came in under budget.

In terms of profitability, how strong a year was 2023 for your business compared to 2022, what you expected at the beginning of the year (budget) and an average year?



In terms of regional performance, firms in the UK were most likely to report an improvement on an average year, with 67% of respondents in the UK doing so and 40% reporting a significantly better performance. This is likely down to the energy and interest rates focus that many props in the UK have, two asset classes that saw significant volatility in 2023.

The performance in the UK compared favourably with the rest of Europe, where just 23% reported a better than average year and just 8% a significantly better year. Indeed 46% of respondents in Europe reported a worse than average year.

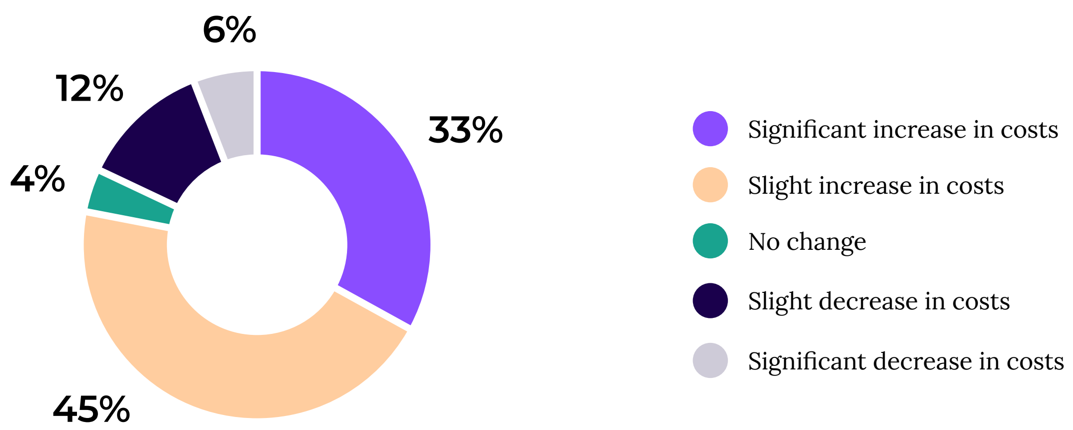
Three-quarters of US-based firms reported that trading in 2023 was about the same as an average year although over half reported declines on 2022. Elsewhere, 43% of firms based in Asia reported worse returns than in 2022 but two-thirds said that it was in line with an average year.

Breaking down the cost base

Underperformance has been driven by a variety of factors, including unreliable liquidity that has hampered opportunities to take advantage of volatility. But a major squeeze on profitability continues to come from costs. Most of the network reported an increasing cost base, with one third saying it had grown significantly in 2023.

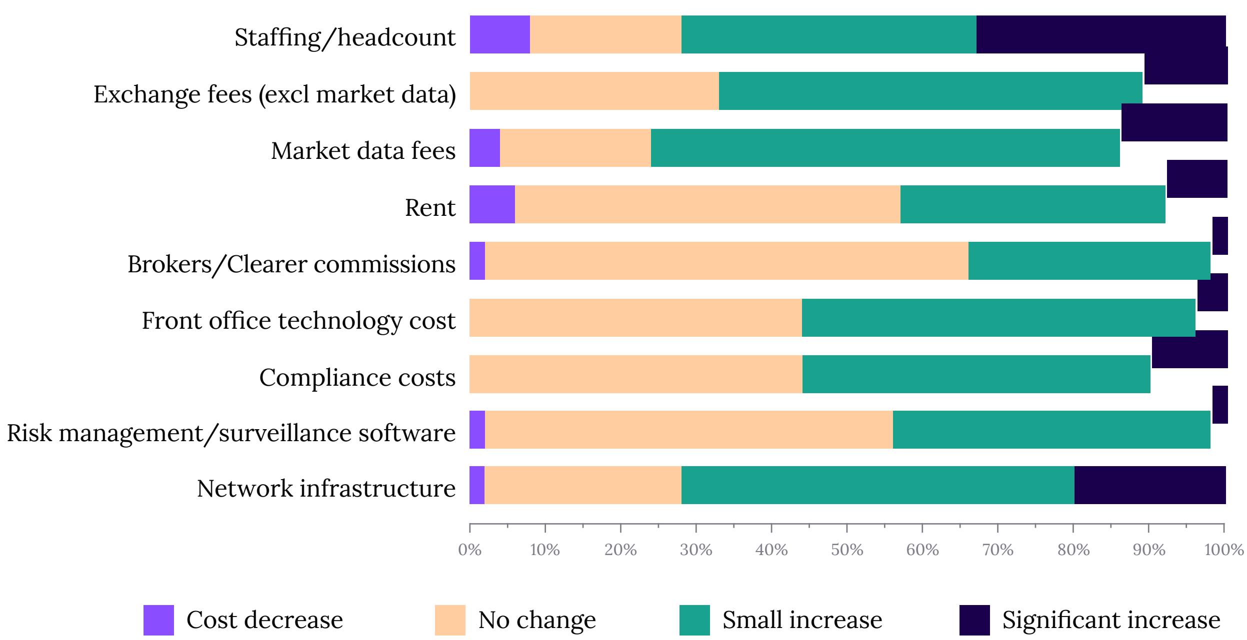
The main drivers of the rising cost base have been staffing and headcount, as firms invested in growth after a strong year at the same time as wages rose in the face of competition for talent. Costs also rose in network infrastructure, exchange fees and market data fees, which continue to exert pressure on the prop trading business model.

Overall, how did your cost base change in 2023?



Brokers and clearing commissions were broadly flat for another year. Clearing providers have generally been able to maintain commissions at current levels owing to the increase in income from margin on client funds they hold. However, with capital charges increasing on clearing firms, 2024 might see an increase in costs for prop firms on this front (see section 3).

How did your cost base change in the following areas in 2023?



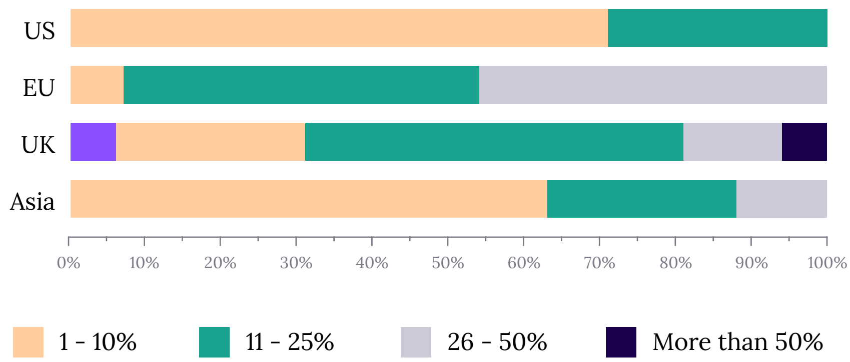
Managing the regulatory burden

Another cost that network members have increasingly complained about is the growing regulatory burden that they face. Senior management is spending an ever expanding amount of its time dealing with new and complex rules and regulations.

At present, 44% of the network are spending between 11% and 25% of their work hours on regulatory affairs, while nearly a fifth said they spend between a quarter and half their time doing so.

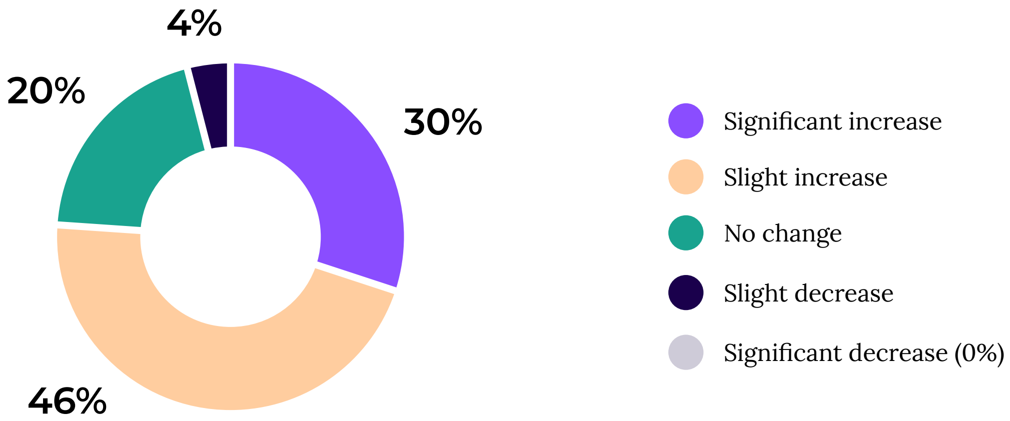
However, there was significant regional difference. EU based executives reported the highest regulatory burden, with more than three quarters of members of the Expert Network spending a quarter to a half of their time on regulatory affairs coming from the continent.

Approximately what percentage of time does your c-suite spend on regulatory affairs?



These proportions have been on an upward trajectory over the last five years. Just over three quarters of members said their regulatory burden had increased over this period, while about a third said they had experienced a significant increase.

How has the amount of time you spend on regulation changed over the past five years?



Hardly any network members expected the situation to change this year, with a majority anticipating that regulation would occupy an even greater amount of their time in 2024. European and UK based firms anticipated the highest rise in regulatory burden.

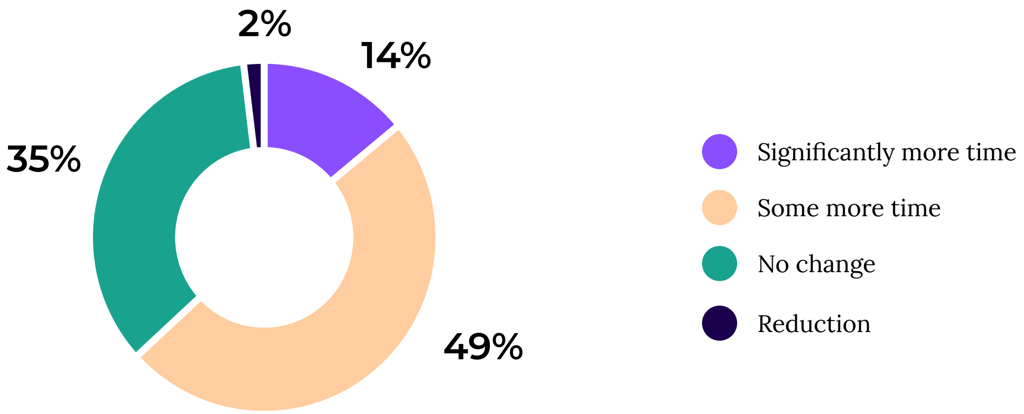
Getting regulation right for proprietary trading firms has long been a challenge for regulators. And there are significant differences in attitudes globally. In the EU and UK, firms came into significant regulatory scope for the first time under MiFiD II. Since then, a raft of new rules has automatically applied to MiFiD II firms, increasing what initially seemed to be an appropriate regulatory framework to near unsustainable levels.

All MiFiD II firms will next year come into the scope of the EU's Digital Operational Resilience Act, a huge workload. Members cited this as an enormous incoming challenge, with a high number of regulatory questionnaires that do not always capture the complexities of digital operations for a trading business. Others cited the political and regulatory landscape in Europe as problematic.

After taking a lighter touch approach, US regulators are following a tougher line with proprietary trading firms. Last year, the SEC moved to require some proprietary trading firms to register under FINRA as broker-dealers. This move has divided opinion in the market and resulted in significant pushback from proprietary trading firms.

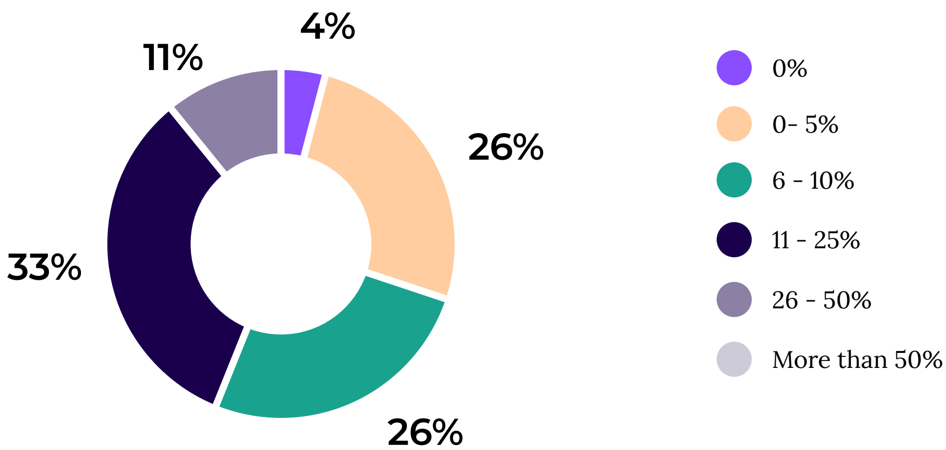
In Singapore, meanwhile, proprietary trading firms are not required to have a licence with the MAS. While this might appeal to firms in the EU that are subject to extensive rules and regulations, several members of the Acuiti Proprietary Trading Expert Network have said that the lack of a licence actually increases regulatory complexity. This is because they have to seek licences in every other country they operate in that requires one. They argue that a licence with the MAS could enable them to passport into other countries, especially across South-East Asia.

How do you expect the amount of time you spend on regulation to change in 2024?



For many, however, the growing regulatory burden is creating a significant drag on performance. One third of the network attributed 11-25% of their total cost base to regulatory mandates, with nearly half of those coming from the UK. Two fifths of those who attributed 26-50% of their cost base to regulation were from the UK.

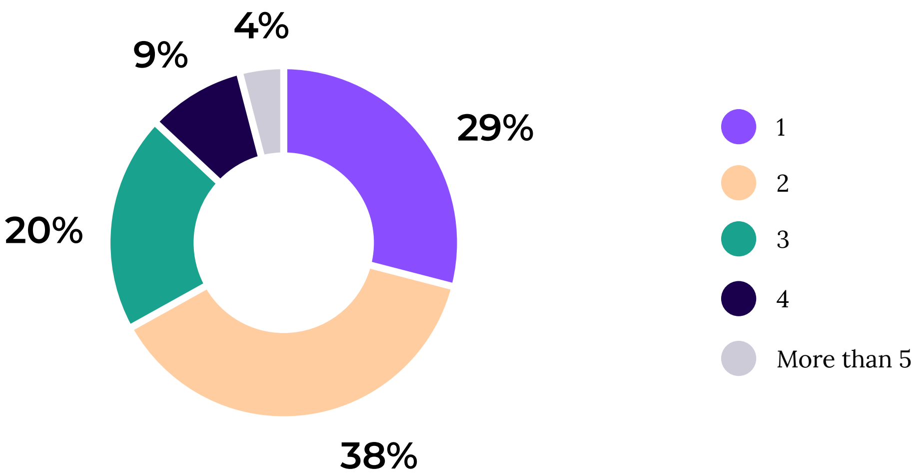
Approximately what percentage of your total cost base is incurred as a direct result of regulatory requirements?



Assessing clearing resilience

The withdrawal of several FCMs from the clearing market since the great financial crisis, coupled with the more recent exit of Credit Suisse from prime broking, has raised concerns in some corners of the prop trading community. Members have identified risks in a potential lack of providers for the market and critical overdependence on those that do service prop trading firms. Nearly two fifths of the network were onboarded with two sell-side clearing provides, while almost a third used just one. One fifth used three, while a minority used more than this.

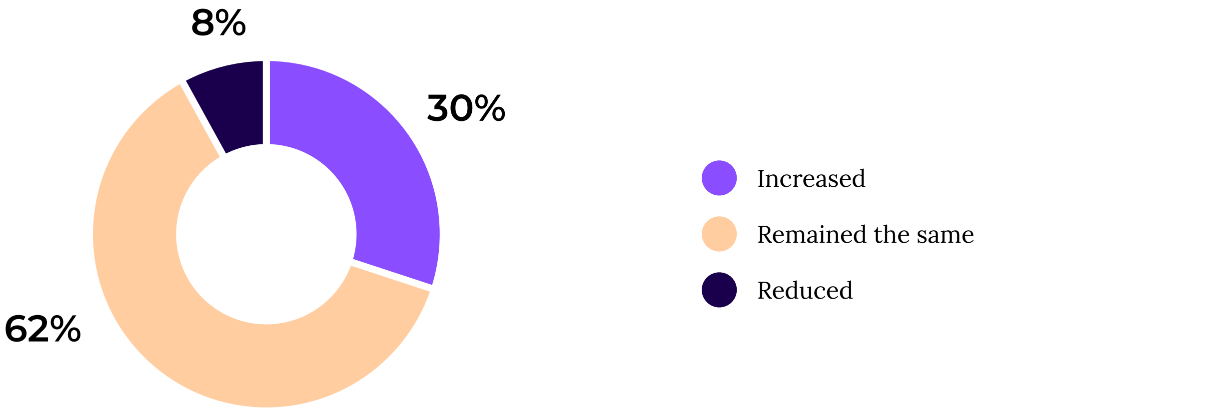
How many sell-side clearing providers is your firm currently onboarded with?



While most of the network have kept the number of clearing providers that they use constant over the past five years, nearly a third had onboarded with new providers.

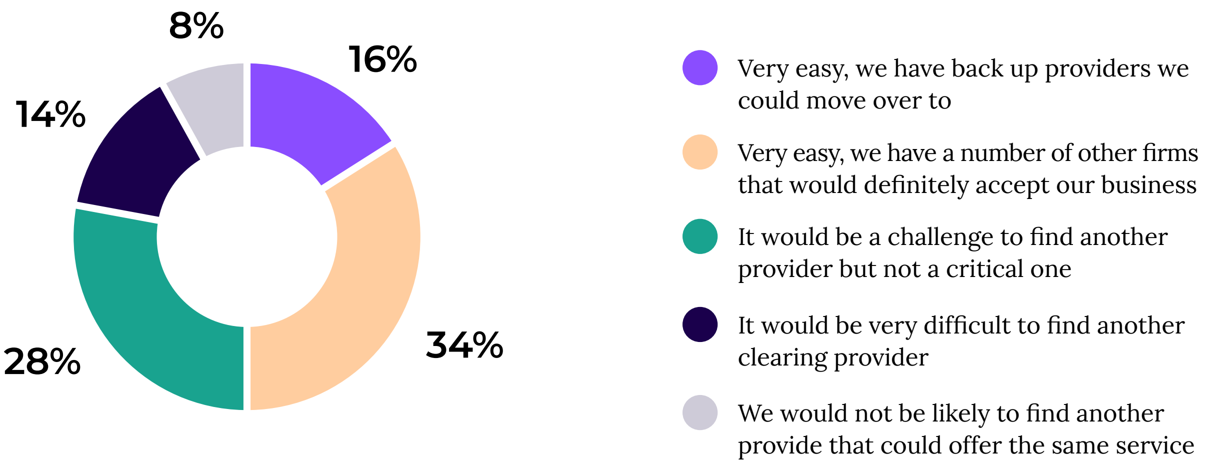
This perhaps reflects an effort to increase resilience in the case of a provider dropping out of the market and also regional expansion among many firms over the period.

How has the number of clearing firms you use changed over the past five years?



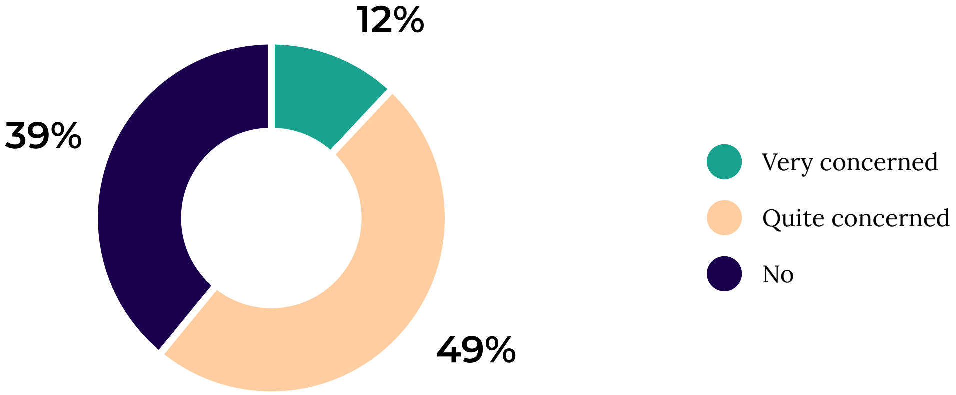
Half of the network were confident they could find a new provider if an existing clearing relationship ceased. Just over a third were confident other clearers would accept their business and 16% had already lined up back-up providers.

How easy do you think it would be to find another clearing provider if your core provider withdrew from the market?



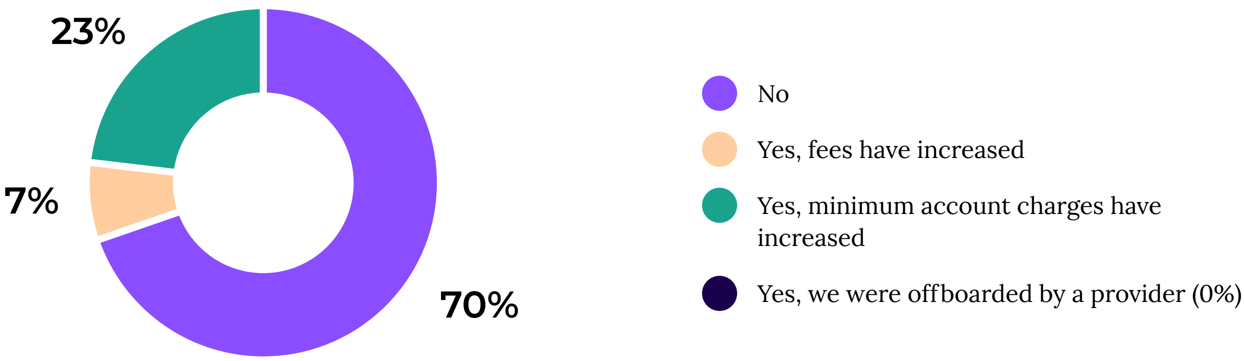
While nearly half of the network was slightly concerned about the number of sell-side clearing providers for prop trading, only a few were very concerned.

Are you concerned about the number of sell-side clearing providers available to the proprietary trading market?



While higher interest rates have boosted revenues for clearing providers, the industry still faces headwinds from the capital requirements that Basel III endgame proposals are threatening for US banks. Over half the network is serviced by a US clearer. So far, the impact on proprietary trading firms remains relatively muted. Just 7% reported that fees had increased. However, almost a fifth said that minimum account charges have increased.

Have you seen any impact on your relationship your US-headquartered bank clearing providers as a result of the Basel III capital requirements imposed upon them?



This quarter's Acuiti Sell-Side Clearing Report, based on a survey of FCMs, found that all US-banks that were in scope for the G-SIB surcharge, a new capital requirement being imposed by US regulators, would raise fees for clients if the rules went ahead as planned. It is likely that the major impact of this will fall on hedge funds and asset managers who typically hold more risk with their banks. However, proprietary trading firms that partner with US banks are likely to also experience fee increases as and when the new rules come into force.

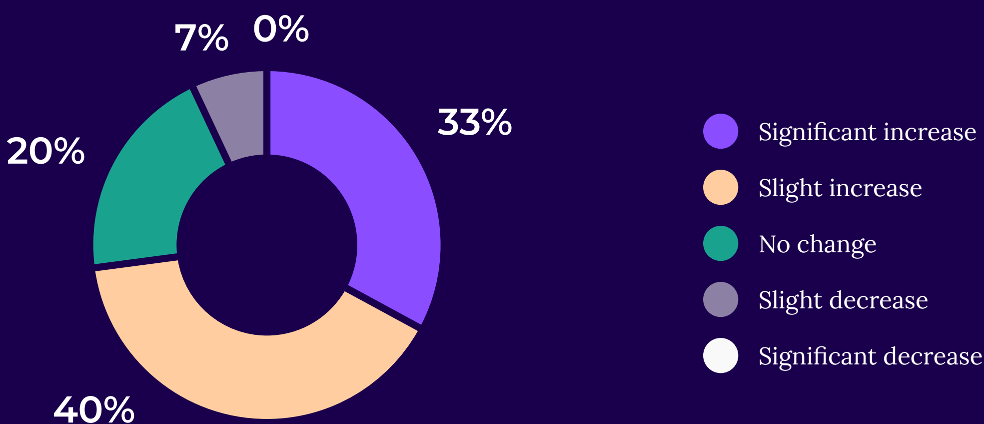
Hot Topics

0DTE rising

Zero-day options are being rolled out by various European exchanges, following the products' enormous success in the US market. The majority of the network that trades equity options is already trading these products, with a bias towards US markets – of the firms that traded 0DTE just 7% only traded them in Europe, while the remainder traded either exclusively in the US or both US and Europe.

0DTE activity is set to accelerate in 2024, with most of the network that traded 0DTE planning to increase their 0DTE exposures and a third saying they would do so significantly. However, only a handful of firms that didn't yet trade 0DTE were planning on starting this year suggesting that growth will come predominantly from existing participants in the market.

Are you planning on increasing your exposures to 0DTE options in 2024?

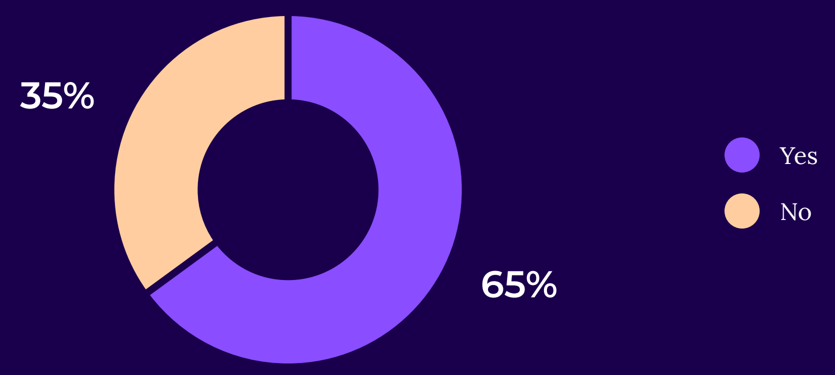


OTC options

Another topic impacting options markets has been the prevalence of OTC options trading over on-screen execution in some markets. This is often driven by the more limited scope for cross-margining at CCPs, often making strategies like covered calls more cost-efficient to execute in OTC markets. Firms can sometimes also leverage bilateral relationships more effectively for pricing than on-screen.

This has a negative impact on exchange-traded markets, reducing liquidity as more market participants elect to execute off-screen. Most of the network agreed that a prevalence of OTC execution was deleterious for overall market transparency and quality. However, there was a significant difference across regions, with 91% of respondents in Europe believing that OTC trading reduces market quality compared with 40% in the US.

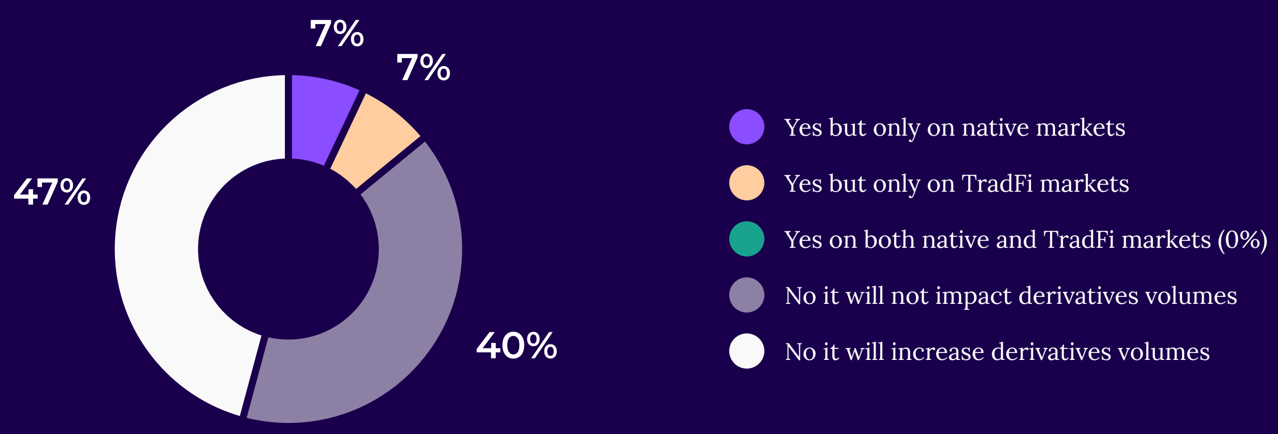
Do you think that the volume of OTC trading in equity options markets reduces overall market transparency and quality?



Bitcoin ETFs

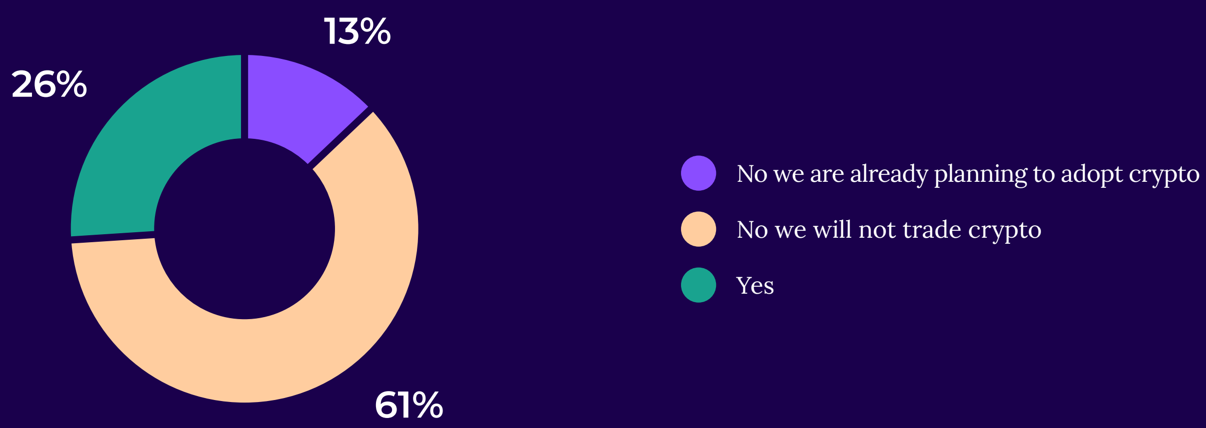
Crypto trading was boosted this quarter, with the approval of bitcoin ETFs in the US strengthening its credibility as an asset class. There have been some concerns that these ETFs will suck liquidity away from derivatives markets, but most of the network that traded crypto do not share that view. Indeed, the largest proportion believe that ETFs will grow activity for all, with a positive impact on derivatives volumes.

Do you think that the approval the bitcoin ETFs in the US will result in lower volumes on derivatives markets?



The launch of ETFs is beginning to shift the dial on institutional adoption. While 61% of firms that didn't trade crypto said that it would not change their view, over a fifth said it would make them more likely to trade. Firms in Europe and the UK are most likely to be not planning on trading crypto, with 82% and 86% respectively not having any plans to do so. Conversely, 50% of firms based in the US and 58% of those based in APAC said that the ETF approval would make them more likely to trade crypto.

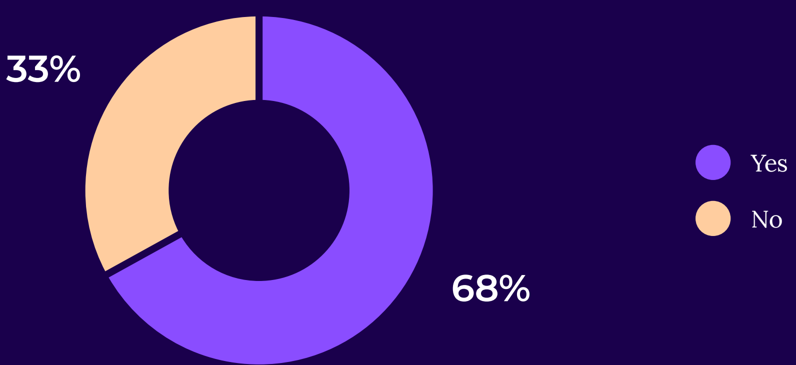
Does the approval of bitcoin ETFs in the US make it more likely that you will trade crypto?



New markets

While appetite for cryptocurrency exposure was divided, the network showed much more consensus on wanting to trade new exchanges in 2024. Many cited APAC, especially onshore India, as a region for expansion, with Brazil also a popular target for growth.

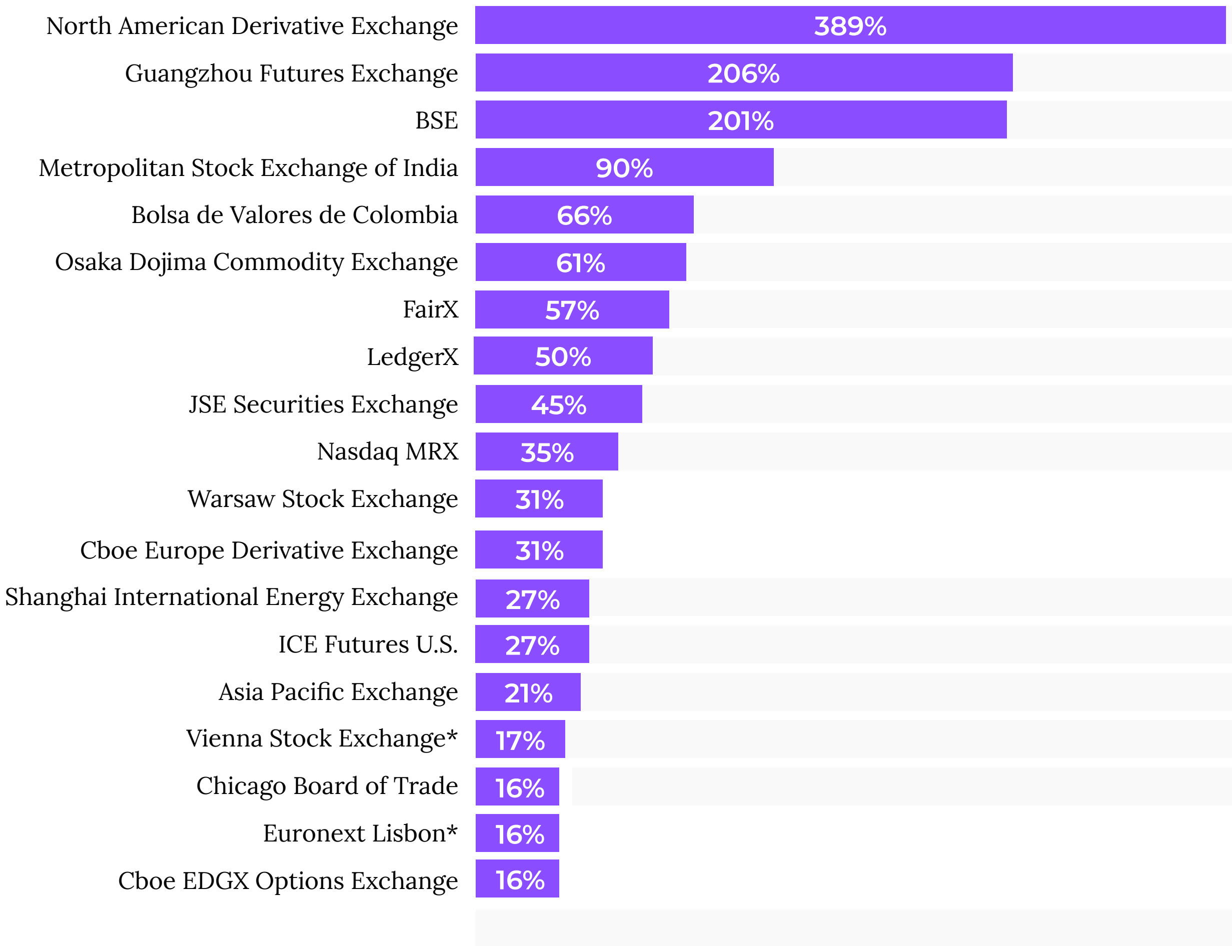
Is your firm planning to trade any new exchanges in 2024?



Contracts and markets

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 contracts

The table below, based on data provided by FOW Data profiles the performance of the top new derivatives contracts launched last quarter, based on average daily volume.

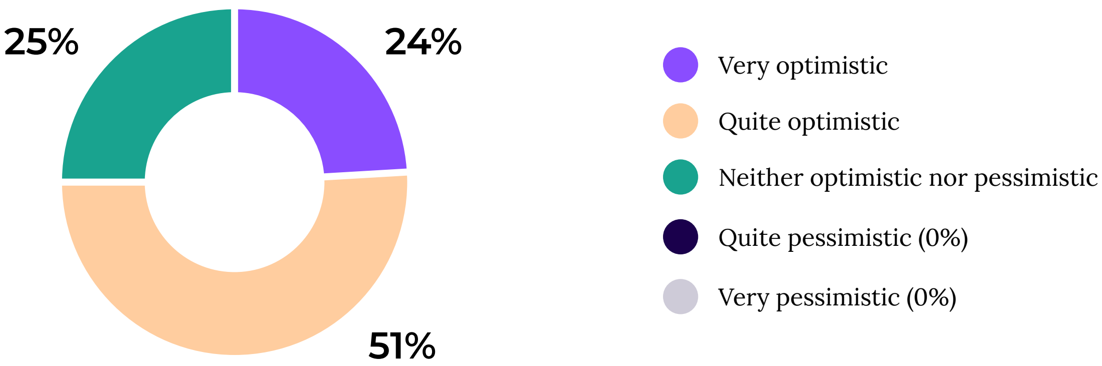
Exchange	Contract	Type	Volume	Open Interest	ADV	Launch
Zhengzhou Commodity Exchange	Soda Ash	Option	**6,644,659**	**430,165**	**110,744**	20-Oct
Zhengzhou Commodity Exchange	Urea	Option	**765,033**	**58,897**	**12,750**	20-Oct
Tokyo Financial Exchange Inc	ETF Futures	Future	**498,636**	**96,248**	**12,161**	01-Nov
Zhengzhou Commodity Exchange	Apple	Option	**292,082**	**14,505**	**4,868**	20-Oct
Zhengzhou Commodity Exchange	Ferrosilicon	Option	**267,397**	**44,242**	**4,456**	20-Oct
Zhengzhou Commodity Exchange	Polyester Staple Fiber	Option	**230,661**	**30,243**	**3,844**	20-Oct
National Stock Exchange of India	WTI Crude Oil	Option	**209,136**	**907**	**3,319**	09-Oct
New York Mercantile Exchange	Micro Natural Gas (Henry Hub)	Future	**173,288**	**26,021**	**2,665**	06-Nov
Zhengzhou Commodity Exchange	Manganese-silicon	Option	**109,631**	**18,838**	**1,827**	20-Oct
Chicago Mercantile Exchange	13-Week US Treasury Bill	Future	**43,734**	**11,072**	**672**	02-Oct
Eurex	DAX End-of-Day Options	Option	**28,942**	**2,145**	**459**	13-Nov
National Commodity & Derivatives Exchange	Crude Sunflower Oil	Future	**3,548**	**1,106**	**59**	12-Nov
Taiwan Futures Exchange	PHLX Semiconductor Sector Index	Future	**1,763**	**103**	**41**	18-Dec
New York Mercantile Exchange - Comex	Micro Gold	Option	**828**	**230**	**12**	02-Oct
Bursa Malaysia Derivatives Berhad	Mini USD/CNH	Future	**48**	**4**	**1**	11-Dec

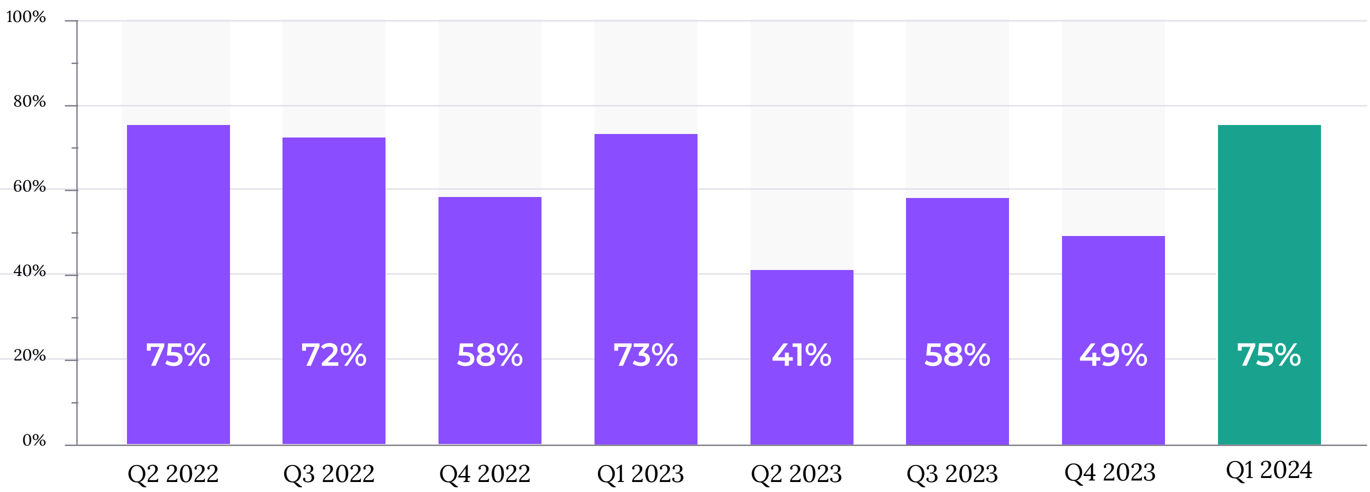
Source: FOW Data

Sentiment index

While the network's view on 2023 was generally down, sentiment for the three months ahead is positive, with a sentiment score of 75%. That represents a significant jump from last quarter's score of 49% and is the highest sentiment score since Q2 2023 — also the all-time high score for the network.

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





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