acuiti management intelligence

Proprietary Trading Management Insight Report

Q2 2023

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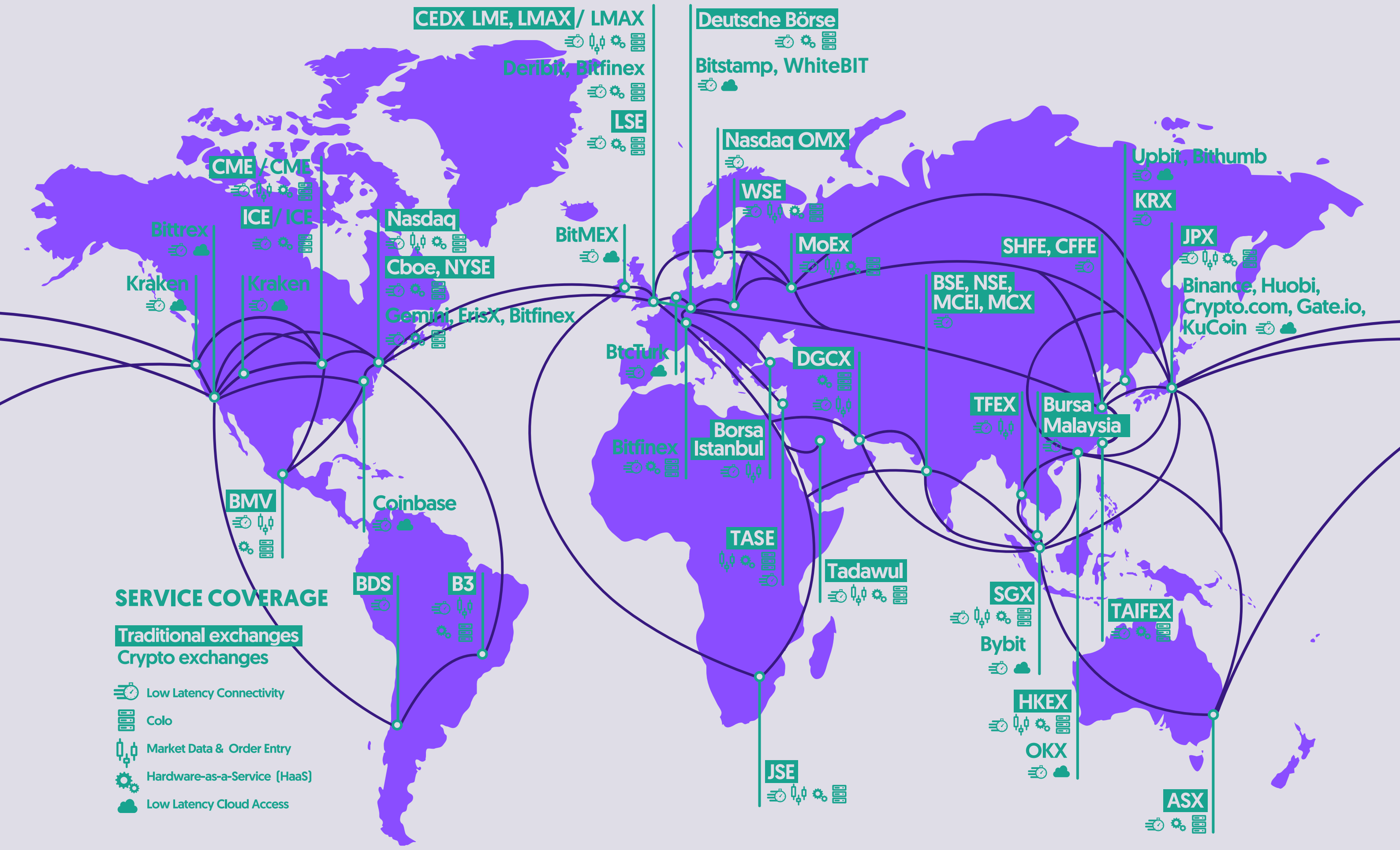

#1 ULTRA LOW LATENCY INFRASTRUCTURE

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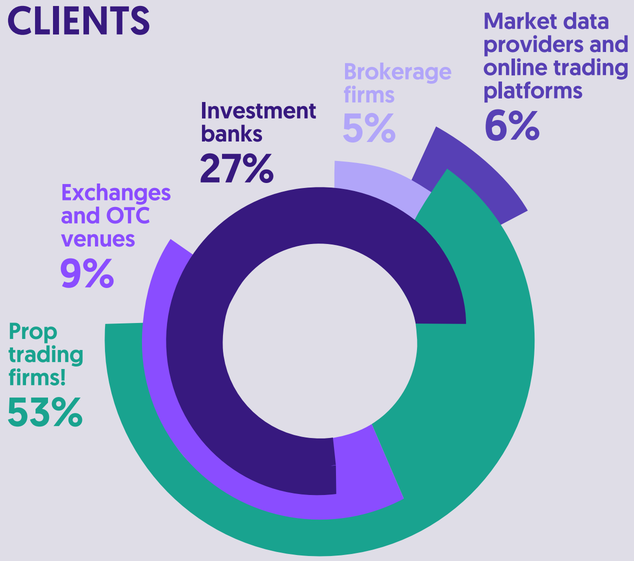

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About this report

Welcome to the Q2 Proprietary Trading Management Insight Report. This report is based on a survey of the Acuiti Proprietary Trading Expert Network, a group of senior executives from across the global proprietary trading community. Each quarter's report is based on questions submitted by the network, by Acuiti and by Avelacom, our report partner.

This quarter we take a look at how regulation in Europe in the form of the Investment Firms Prudential Regime is putting significant pressure on UK and EU proprietary trading firms' ability to compete and provide services to the market.

In addition, we look at global equity listed derivatives liquidity, plans for headcount growth and hot topics suggested by the network including zero-day options, regional growth, Asian service providers and spot commodity trading.

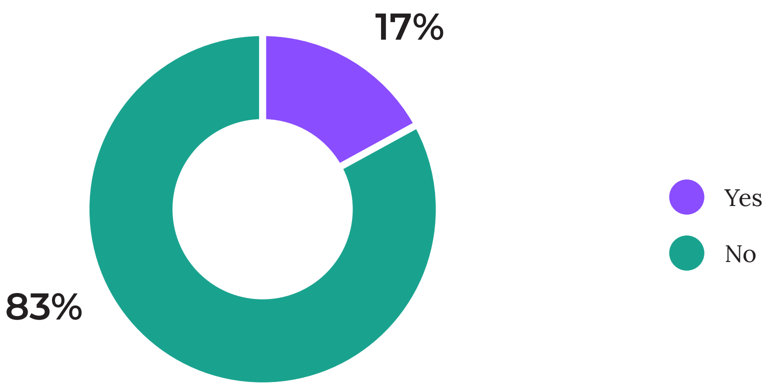
The urgent need to reform IFR/D in Europe

The introduction of the Investment Firm Prudential Regime in the form of a regulation and directive (together IFR/D) in Europe was intended to provide a more manageable governance and capital structure for proprietary trading firms. The result is sky-high capital costs and firms looking to relocate their trading operations outside the region.

IFR/D was conceived to introduce more proportionate rules for Mifid II investment firms across governance and capital requirements after Mifid II had brought thousands of firms, including most proprietary trading firms in the EU, into a regulated environment.

The view was that the current capital rules (in the form of CRR/CRD) and other regulatory requirements of being an EU regulated entity were too high for smaller firms. And so IFR/D was developed to provide a lighter touch regime for smaller and less-systemically important firms.

The IFR/D was intended to provide a simpler regulatory regime for proprietary trading firms. Do you think the new regime more accurately captures prudential risk?



The verdict of proprietary trading firms two years after the rules were introduced is overwhelmingly negative. Just 17% of the Acuiti Proprietary Trading Expert Network with operations in the UK or EU said that IFR/D accurately captured the prudential risk they pose to the market. Talk to a different proprietary trading firm and you have a different set of challenges to the regulation, as IFR/D impacts firms of varying size in very different ways.

Governance rules

The first challenge firms face is in rules around governance. Under IFR/D, proprietary trading firms are subject to remuneration and governance requirements, which includes new remuneration rules and having to set up bonus deferral and claw-back schemes as well as the establishment of an independent board.

Acuiti spoke to several firms, some with very small numbers of employees, who were facing requirements to set up independent boards and introduce new bonus structures for traders, resulting in increased salaries and cost bases.

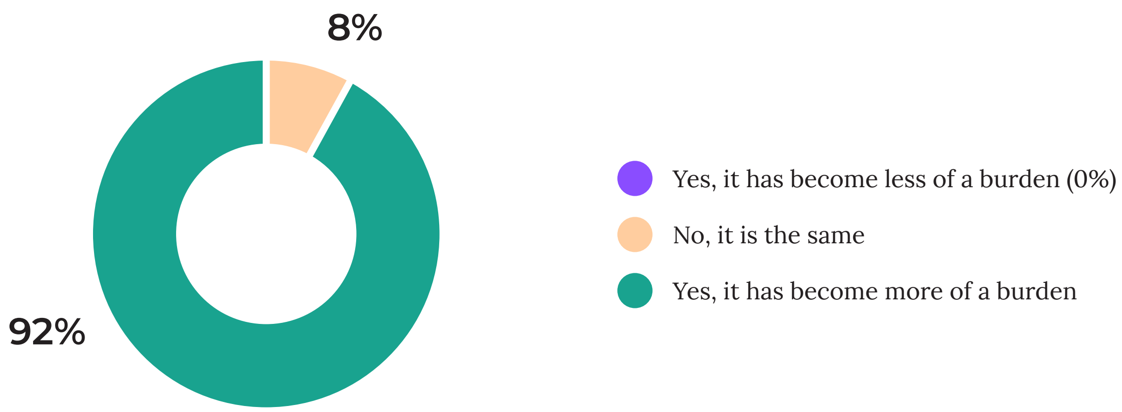
Under the governance rules, firms need to establish remuneration committees and to define material risk takers who are subject to various requirements including malice and claw-back policies.

Many firms Acuiti spoke with were unclear exactly what constituted a material risk taker. Traders, for example, as part of their roles take and manage risk. However, to designate every trader in an organisation as a material risk taker would wreak havoc with existing salary and bonus policies.

IFR/D also imposes new reporting requirements on firms, already struggling under the onerous requirements of Mifid II and Emir.

Overall, 92% of respondents said that their reporting requirements had increased with none saying they had decreased. One respondent to the survey said that the reporting requirements had become "ridiculous".

Has the new regime changed your reporting requirements?



Class action

A bigger issue than the increased costs imposed from the governance rules for many firms are the capital requirements that IFR/D imposes. For many firms, these requirements pose an existential threat.

IFR/D uses three items to calculate capital requirements (in addition to other elements, such as those related to wind-down costs and ICARA operational risk assessments).

These items are: a fixed overhead requirement equal to a quarter of the firm's annual overheads; a permanent minimum capital requirement of between €75,000 and €750,000 depending on the size and activities of a firm; and an overall "K-factor", which is designed to reflect the risk that each firm poses to clients, the market and the firm itself.

IFR/D sets out three classes of firm, with Class 3 firms exempt from many of the regulations. However, the way that Class 3 firms are defined means that no proprietary trading firm can qualify.

This is significant, as firms in Classes 1 and 2 are subject to the capital rule calculations based on K-Factors. Depending on what a firm trades the impact on their capital requirements can be vast. Firms trading futures, in particular interest rate futures, are understood to be particularly badly hit by the capital requirements.

The regulation sets out a number of "K-factors" that are used as the methodology to calculate capital requirements. When IFR/D was in development, the proprietary trading community successfully lobbied for the introduction of a new K-factor: K-CMG.

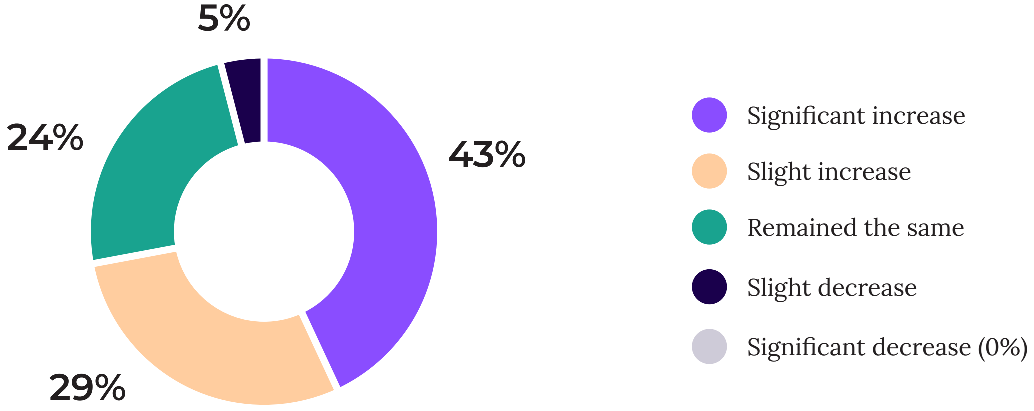
K-CMG was designed to reflect the risk that proprietary trading firms posed to the market and was therefore more in-line with the levels of margin required by clearing firms, as the capital requirements in the US are designed.

However, while the European Commission allowed the application of K-CMG, it insisted on onerous requirements, such as a minimum threshold tied to the highest point of volatility in a given look-back period and a 1.3x multiplier. This not only creates uncertainty but also, following the recent spikes in volatility, creates an immensely high threshold for firms.

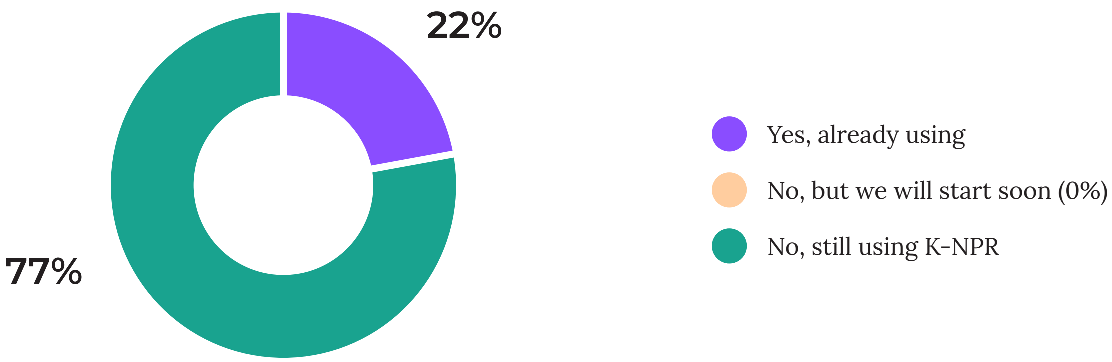
In addition, different clearers use different methodologies to calculate margin and there is no clear description of how risks across clearers should be aggregated. Also, firms often hold margin as a lower tier of capital than is required to qualify as K-CMG regulatory capital.

As a result, most firms in the network are still using the K-NPR calculation, which is more closely aligned to the bank-designed capital rules. However, K-NPR is fundamentally flawed for proprietary trading firms.

Has the new regime changed your capital requirements?



Are you using the new K-CMG method to calculate market risk?



Because K-factors generally calculate exposures on a notional value and do not sensibly allow for netting, the capital figures that are being calculated for proprietary trading firms are vast.

In many instances, K-NPR results in capital requirements that are at many times multiples of current margin requirements. Considering margin is the basis on which the derivatives industry manages risk, it is perverse that capital requirements should be such high multiples of margin.

Acuiti spoke with one firm, currently operating in the UK under a five year locals exemption that would be required to raised more than £100m in capital just to meet the capital rules when the exemption expires in four years. This is more than five times the level of margin that they are required to pay.

For many smaller firms, therefore, the capital rules pose an existential threat to their ability to continue to operate once the exemptions expire and most will be forced to operate outside the scope of Mifid or close as a result.

The Class 1 threshold

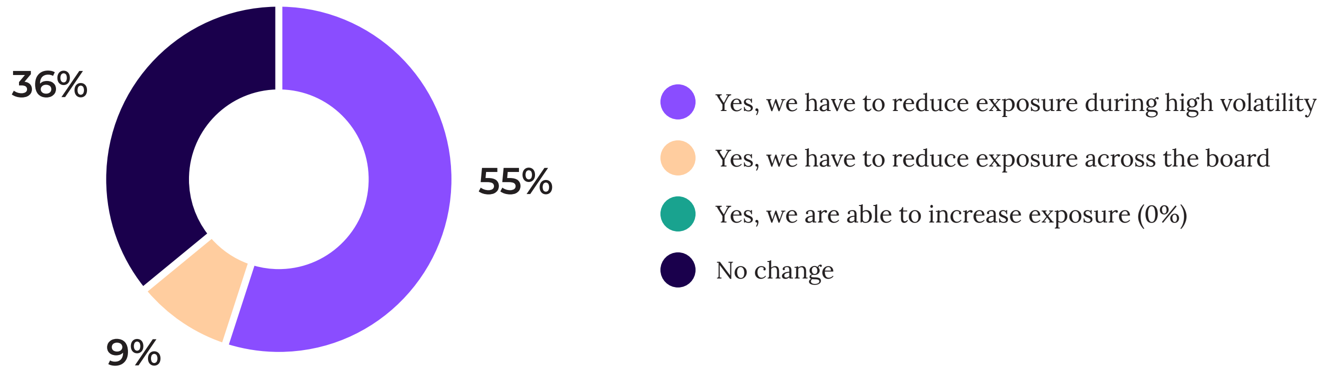
For the larger firms, IFR/D poses very different challenges. Any firm that exceeds €15bn in relevant balance sheet will be classified as a Class 1 Minus firm and subject to the prudential regime set out for banks in CRR. Firms that exceed €30bn come into Class 1 and in which they are required to register as a credit institution and will be subject to the same prudential requirements as large banks.

A key question currently is whether these asset thresholds apply only to firms' European operations or whether its application is global. The EU has agreed that local authorities have some discretion over whether to include global operations in the threshold.

This creates further uncertainty and the risk that firms will move operations out of the EU to avoid coming over the threshold.

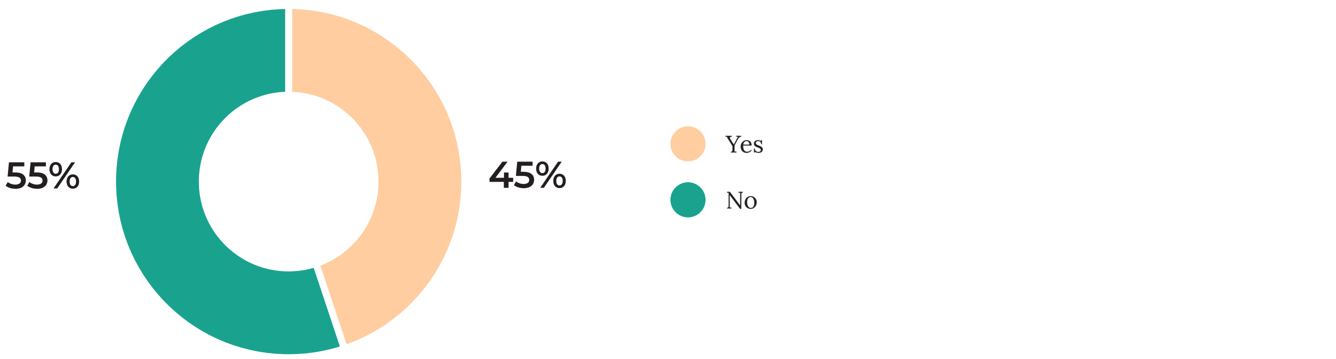
Already the impact is being felt in EU markets. Almost two thirds of firms, including over 90% of the larger ultra-low latency firms that account for the majority of trading volumes and are most exposed to the risk of classification as a Class 1 firm, reported in this study that they were being forced to reduce exposure during market volatility to reduce their balance sheet and elimiate the risk of crossing the Class 1 threshold.

Has the new regime impacted your ability to make markets?



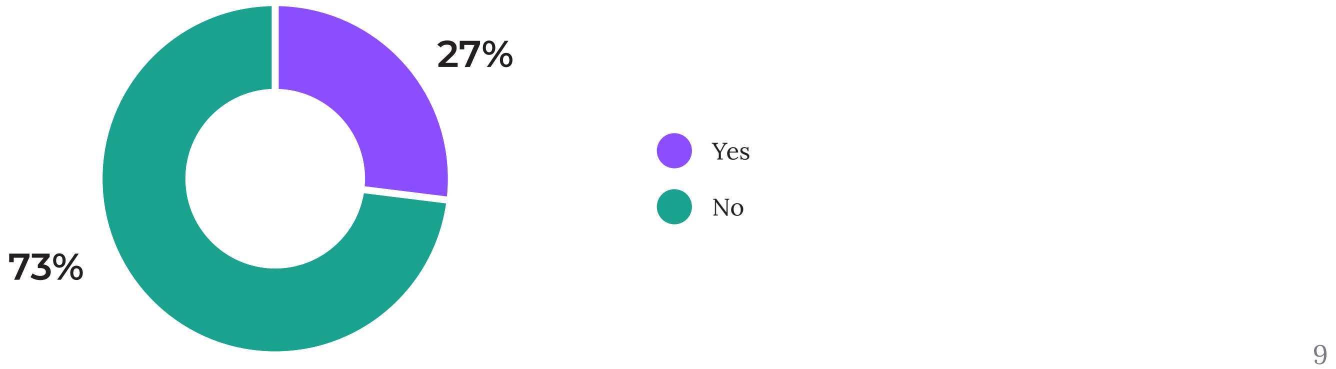
Others are considering moving trading operations away from the EU. Almost half of firms in the survey said that they were considering moving trading activities outside the EU or UK in order to reduce balance sheet exposure under IFR/D.

Have you considered moving trading activities outside the EU or the UK in order to reduce balance sheet as a result of IFD/R classification thresholds?



Most significantly, 27% of firms said that they were considering giving up their Mifid II licence as a result of the overall increased regulatory burden in the EU. One common complaint from firms has been how new rules for investment firms are layered on to existing rules, resulting in an increasingly onerous and unstoppable regulatory burden.

Are you considering giving up your Mifid II licence as a result of the increased regulatory burden?



The Sword of Damocles

While most proprietary trading firms accepted the merits of Mifid II when it was first launched in the mid 2010s, the automatic addition of new rules has become unsustainable for many. Some high profile firms have already given up their Mifid licence and now trade only on markets outside the EU while continuing to locate in the block.

The great unfairness for firms with Mifid licences is that firms in the US are able to trade on European markets without the burden of Mifid II and its associated regulations. Unless this is addressed, Europe is likely to experience a continual drip of departures of proprietary trading firms and an absence of new start-ups, furthering liquidity issues and undermining the integrity of its capital markets.

Already, firms are facing lower opportunities in the UK and Europe (see section: Hot Topics). This will only accelerate unless the EU takes remedial measures ahead of the review of IFR/D in 2025.

The impact is already being felt across the market. While the UK has granted a temporary exemption from K-Factor reporting for local firms, in other jurisdictions such as Amsterdam, firms face a ratcheting up of capital rules each year.

For many firms a Sword of Damocles hangs over them, facing either an annual squeeze that for many will become too great or a cliff edge when the exemption expires.

Proprietary trading firms do not deal with client money. Therefore the capital at risk is that of the shareholders and other stakeholders. This is not taken into account in the current regulatory framework.

Nor are the current rules in any way proportionate. That a proprietary trading firm with margin requirements in the low tens of millions, based on the risk its positions pose as judged by its clearing member, should face capital charges of more than €100m is clearly absurd.

IFR/D must be rewritten to ensure that capital charges reflect the risk of the firm's bankruptcy to the wider financial system. Derivatives exposures must be calculated on a non-notional basis and realistic netting has to be taken into account to reflect the actual risk a firm is exposed to.

But more fundamentally, the EU and UK regulators must consider the risk that proprietary trading firms pose to the financial system. Competition between firms is intense and historic failures of large institutions, such Ronin Capital in 2020 have had very little to zero impact on the stability of financial markets.

At the very least, the rules should be rewritten so that most proprietary trading firms in the UK and EU are classified as Class 3 firms - a designation specifically designed to apply to smaller, non-interconnected firms. In addition, no proprietary trading firm should be classified as a Class 1 firm.

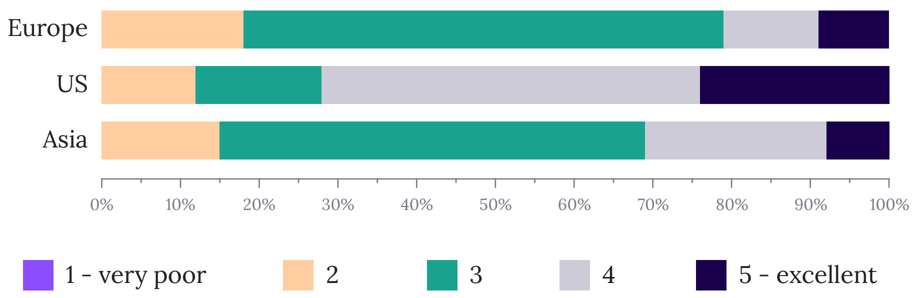
Regulators have long mis-understood proprietary trading firms. To continue to do so risks eliminating many firms' ability to operate, the exact reverse of what the regulations are intended to do.

Equity liquidity

In the second of our liquidity series, we take a look at the global equity markets. Overall, members of the Proprietary Trading Expert Network reported better liquidity in equity futures and options than they did in fixed income contracts (see Q1 report).

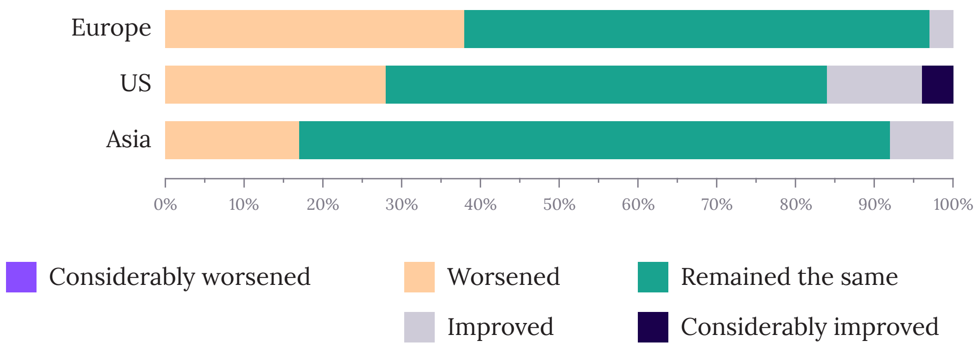
However, the picture is mixed across the globe. In futures, the US had the best liquidity with almost three quarters of respondents rating it either 4 or 5 out of five. Liquidity on the CME was seen as the best compared with the other key markets.

How would you rate the liquidity in the futures contracts you trade on exchanges in the following regions?



In Europe, Eurex was the best exchange for futures liquidity, with around a fifth of respondents rating it as excellent. Whereas for ICE Futures Europe, around the same percentage of respondents rated liquidity at 2 out of 5.

Over the past 12 months how has liquidity changed in the futures contracts you trade at the following exchanges?



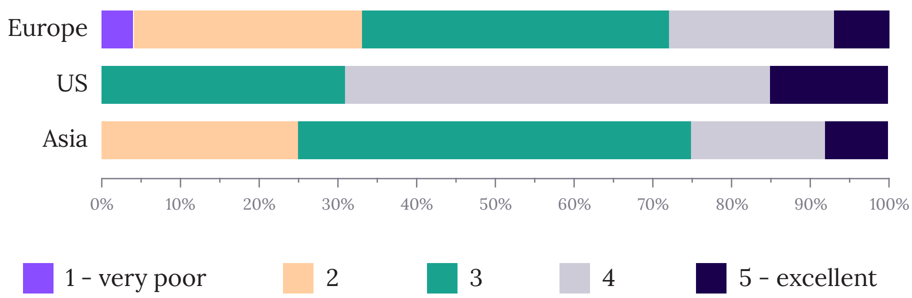
However, while liquidity was reported to be better in equities than in fixed income, more respondents pointed to a worsening than an improvement over the past 12 months.

In addition, liquidity in options markets is considerably worse than in futures, particularly in Europe where a third of respondents said that liquidity was poor.

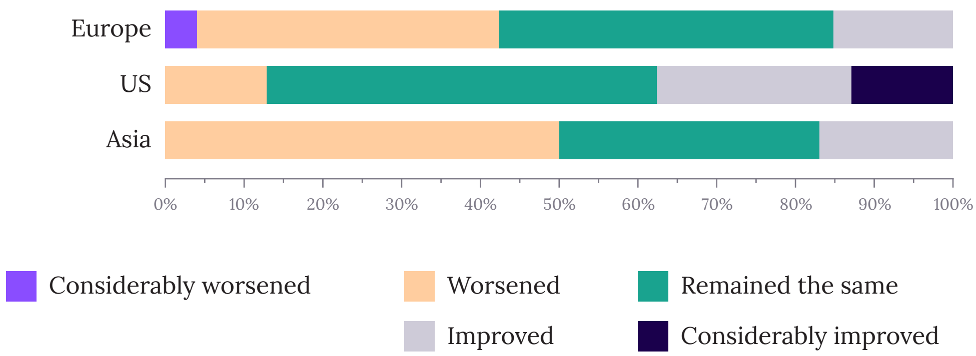
Again Eurex was seen to have the best liquidity in listed equity options among its peers.

Liquidity in options markets has been a long-standing challenge for several regions but it is getting worse with around half of respondents reporting a worsening over the past 12 months in Europe and Asia.

How would you rate the liquidity in the options contracts you trade on exchanges in the following regions?



Over the past 12 months how has liquidity changed in the options contracts you trade at the following exchanges?



Section 3

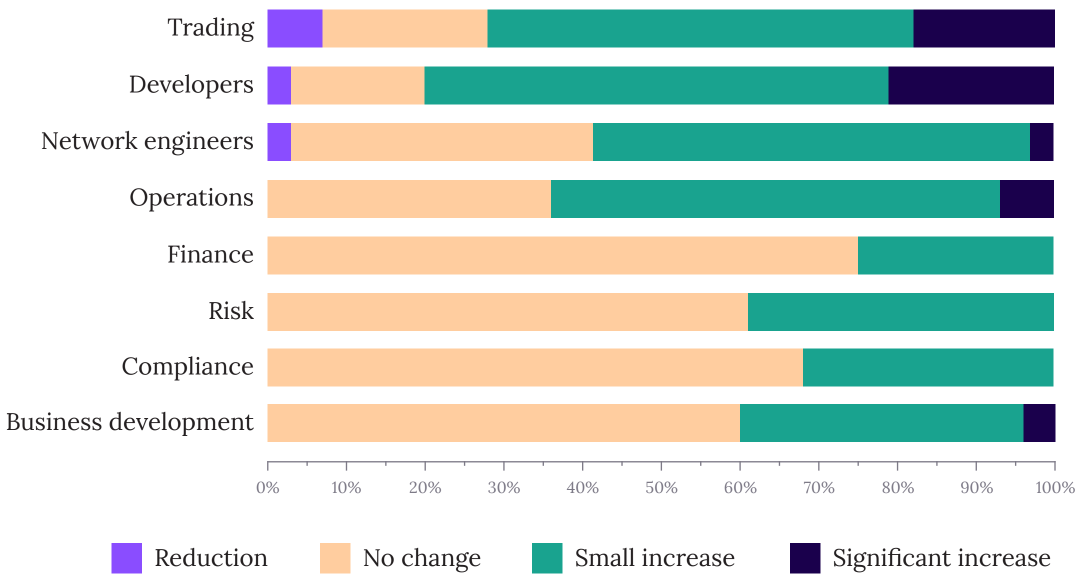
Headcount plans

The cut-throat market for talent among proprietary trading firms is likely to further accelerate in 2023 as members of the expert network reported little let-up in their hiring plans.

Firms were most aggressively hiring traders and developers with just 28% and 20% of respondents not planning to hire in those roles.

Hiring plans were more stable in other roles, with a majority of firms reporting no plans to increase headcount in finance, risk, compliance and business development.

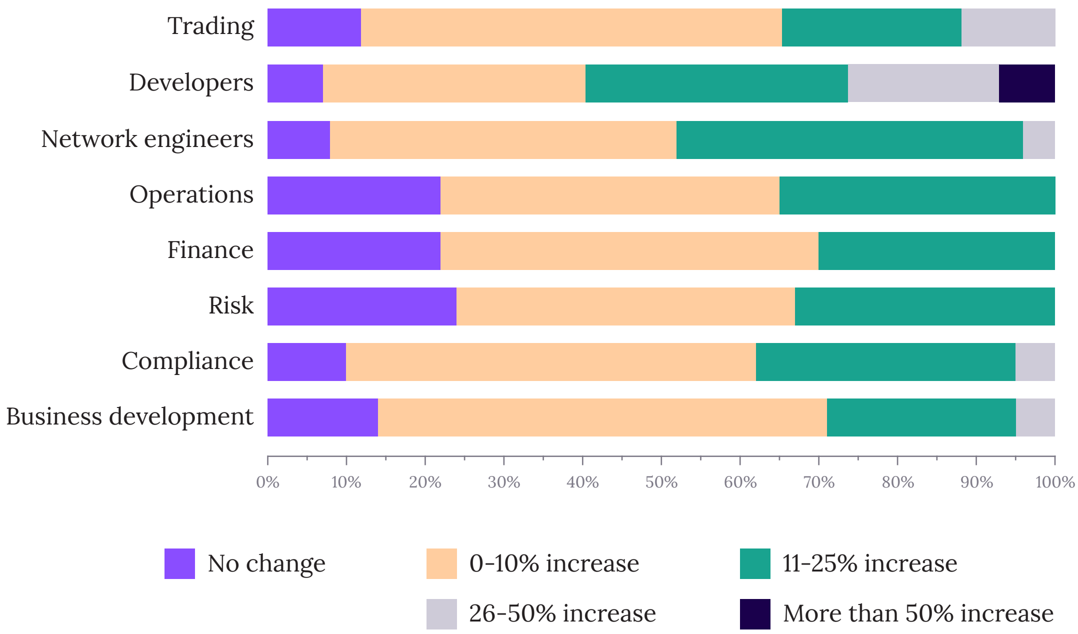
Will you grow your headcount in any of the following areas in 2023?



Salaries are rising sharply amid the competition for talent, particularly in the US market for developers where a majority of respondents reported increases of more than 25% in basic salaries over the past 12 months. With profits up on the back of a strong year for most proprietary trading firms in 2022 (see Q1 Insight Report), bonuses were also high last year. The risk is that with regulatory costs and other costs of operation also rising, firms will be forced to cut staff during the next downturn to mitigate the significant rise in fixed costs accumulated since the Covid pandemic.

However, for now, with volatility expected to remain across global markets, the main concern for executives remains finding the right talent to capitalize on the opportunities that current market conditions present.

Have you seen wage appreciation over the past 12 months for basic salaries in any of the following roles?



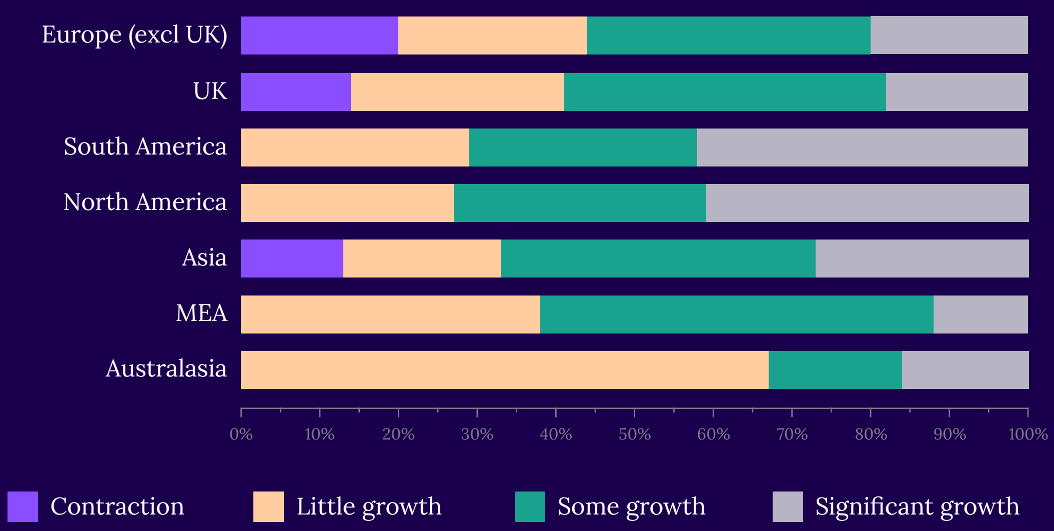
Hot Topics

This section profiles some of the topics suggested by members of the network.

1 Regional growth

Proprietary trading firms have seen the most profit growth from South America and North America over the past five years, with the growth languishing in Australasia and weak growth experienced in Europe. The retail boom in the US and the continuing growth of Brazil's derivatives and equity markets account for the majority of the uplift experienced by firms in North and South America while regulatory overstretch in Europe has significantly curtailed firms' ability to profit.

In terms of profit growth over the past five years for your business how have the following regions performed?



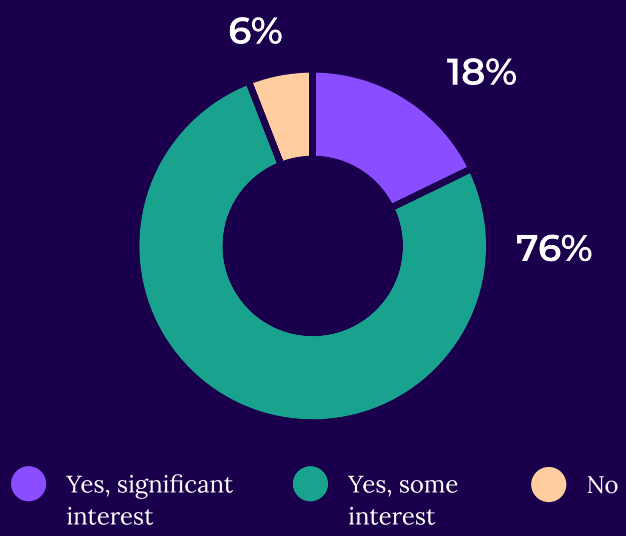
2 ODTE

The roaring success of 0-day options in the US promoted one member of the expert network to ask whether there was similar potential in European markets. Just 6% of respondents said that they did not think there was potential while almost a fifth believed there was significant potential.

The listed derivatives retail market in Europe has been subdued when compared to the US by several factors, ranging from different pension policies to other products offered to retail clients.

However, with Eurex and Euronext both expanding their short-term options offerings, now could be the time for growth in the European options market, both across retail and institutional trading.

Do you think that there is end-client or retail interest for more 0-day options in European Equity Index products?



3 Asian markets

As firms seek to expand their trading operations, one member of the Expert Network asked which exchanges and vendors serving the Asian market the network felt had the best understanding of the proprietary trading business. Respondents in Asia reported that SGX was the exchange that most understood their business and TT was the vendor that they felt best served the local proprietary trading market.

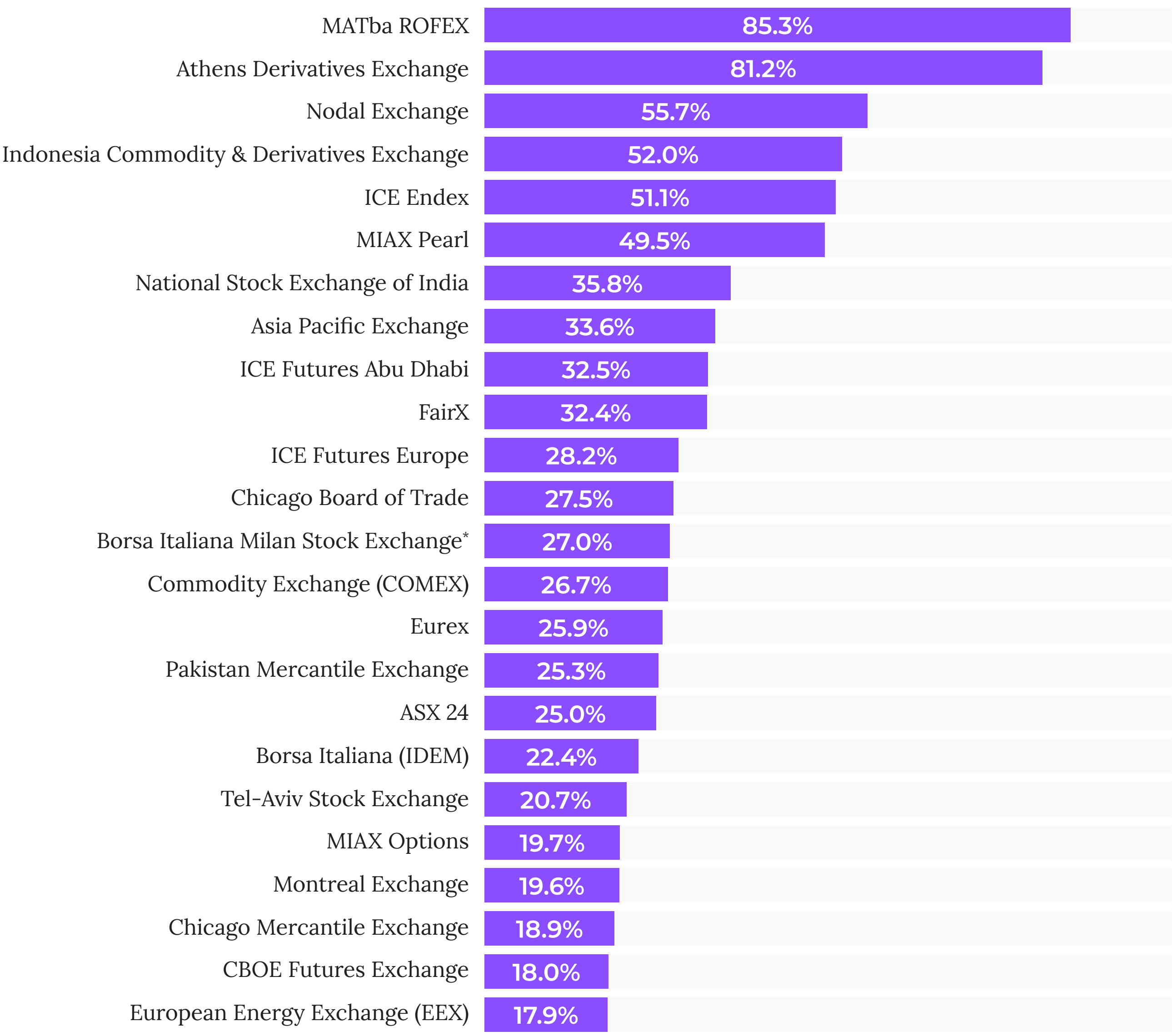
4 Spot commodity trading

Proprietary trading in commodity derivatives has long been a key element of many firms' strategies. This quarter we asked whether firms traded spot as well as derivatives. Around a third of the firms in the network traded commodities and of those a quarter traded spot as well. Of the firms that traded spot, all traded predominantly electronically with most trading across 2 to 5 venues.

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 contract watch

The table below, based on data provided by ETD (formerly Euromoney TRADEDATA), profiles the performance of the top 10 new contracts launched last quarter, based on average daily volume.

Exchange	Contract	Type	Volume	Open Interest	ADV	Launch
Multi Commodity Exchange of India Ltd	Crude Oil Mini	Future	**677,952**	**5,491**	**15,766**	03-Mar
Multi Commodity Exchange of India Ltd	Zinc Mini	Future	**130,025**	**2,732**	**3,023**	22-Feb
Multi Commodity Exchange of India Ltd	Natural Gas Mini	Future	**106,024**	**6,898**	**4,609**	14-Mar
Multi Commodity Exchange of India Ltd	Aluminium Mini	Future	**57,946**	**2,419**	**1,347**	20-Feb
Multi Commodity Exchange of India Ltd	Lead Mini	Future	**8,989**	**356**	**209**	22-Feb
Tokyo Financial Exchange Inc	3 month TONA	Future	**2,216**	**112**	**36**	20-Mar
New York Mercantile Exchange - Comex Division	Molybdenum Oxide (Platts)	Future	**170**	**165**	**3**	13-Mar
Montreal Exchange	One-Month CORRA	Future	**151**	**152**	**2**	23-Jan
Singapore Exchange Derivatives Trading Limited	Nikkei 225 Climate PAB	Future	**95**	**4**	**2**	20-Mar
Eurex	Three-Month Euro STR	Future	**32**	**11**	**0**	23-Jan

Source: EuromoneyTRADEDATA

Section 6

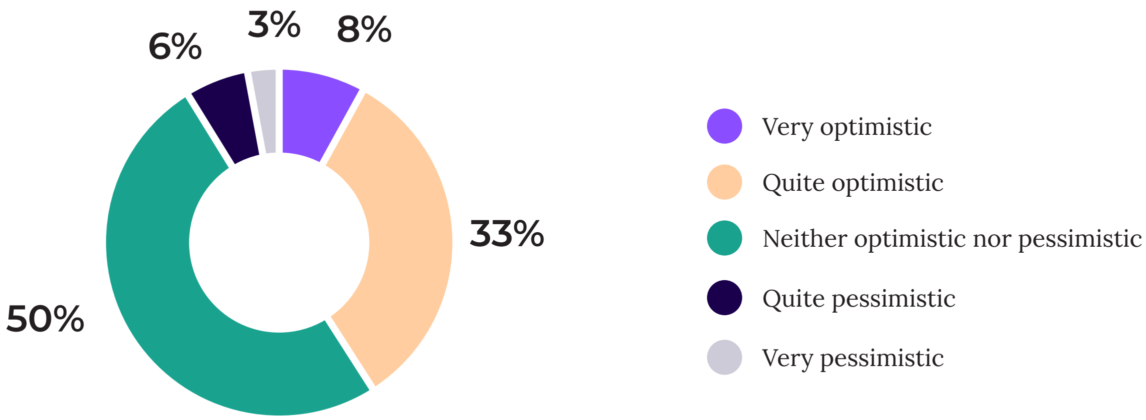
Outlook

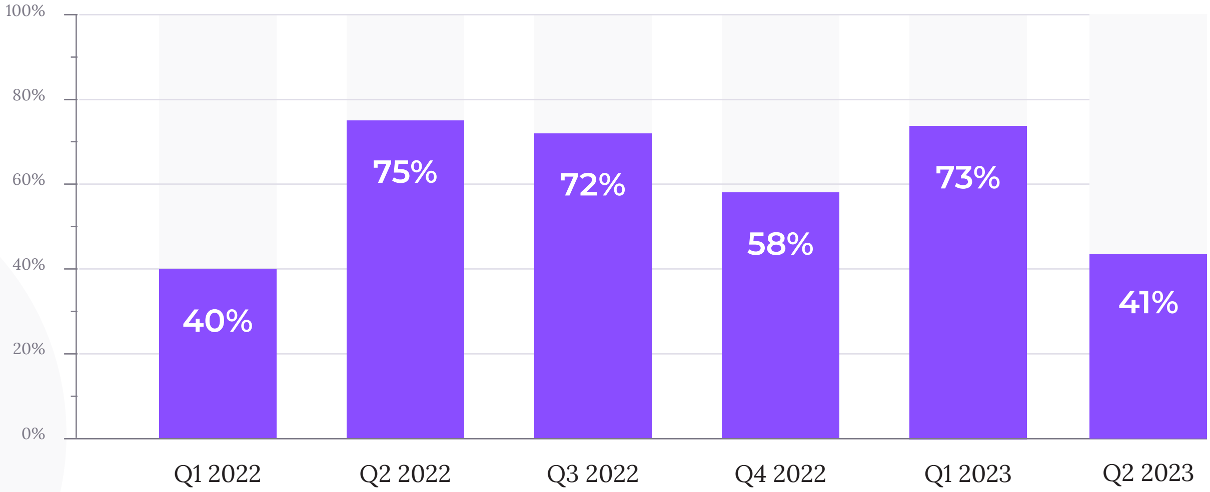
Sentiment among proprietary trading executives dropped sharply last quarter, as volatility across global markets slowed.

Overall, just 41% of respondents said that they were optimistic about the next three months, the lowest reading since before the Russian invasion of Ukraine in Q1 2022.

In addition, 9% of respondents were either quite or very pessimistic, up from none last quarter.

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





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