Acuiti Proprietary Trading Insight Report

Q3 2024

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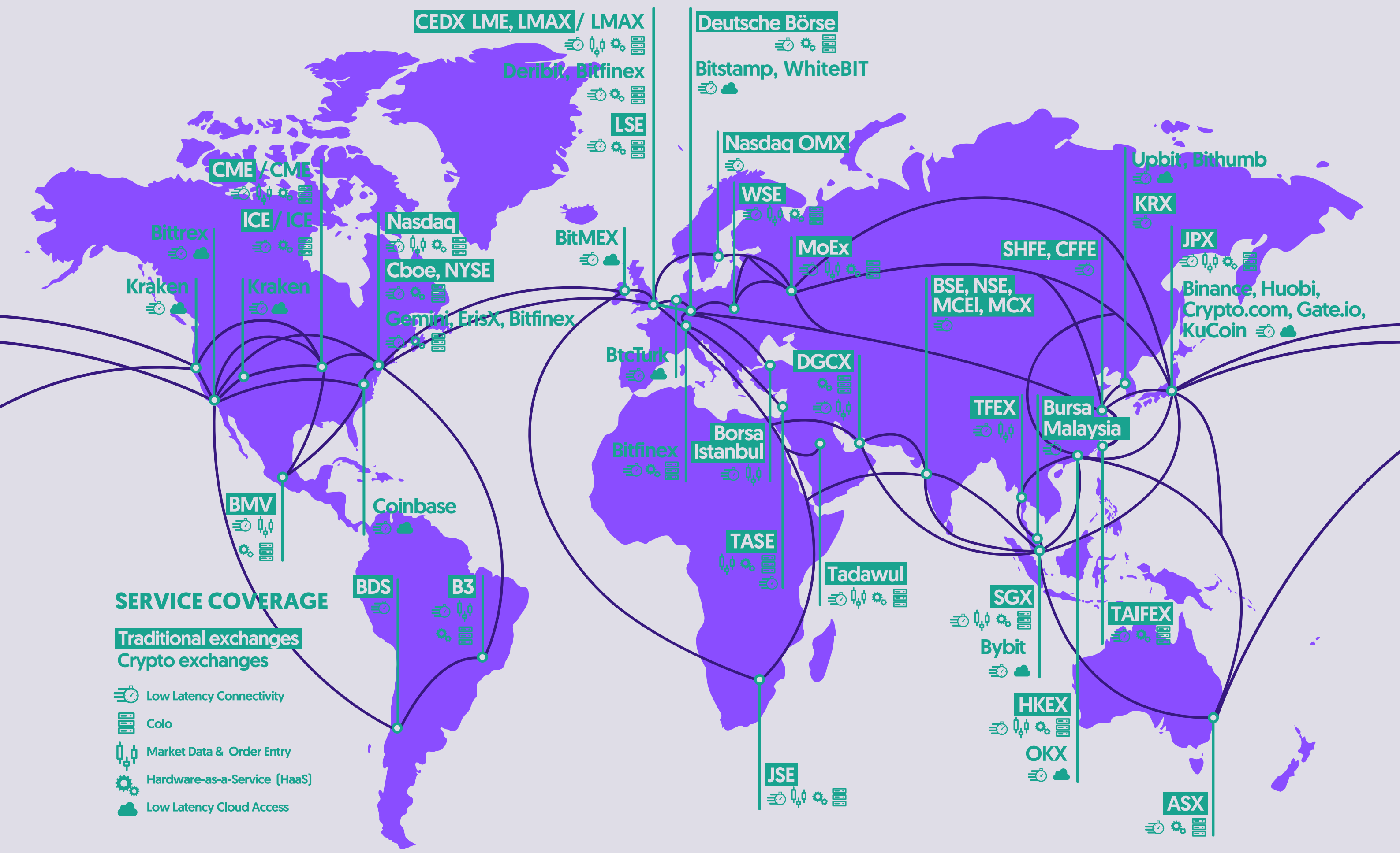
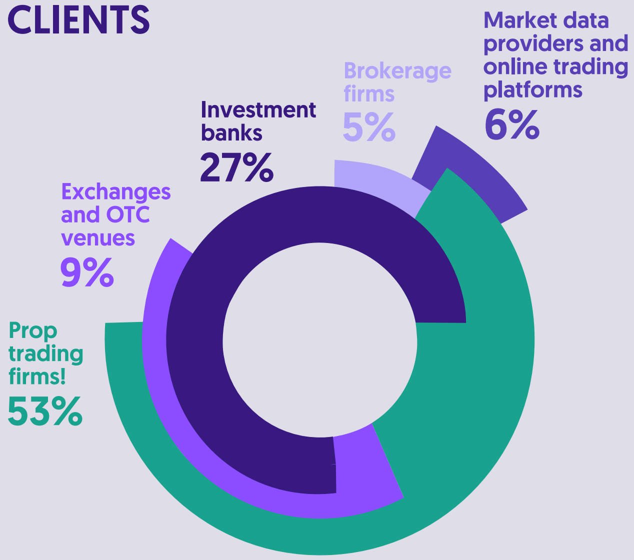


#1 ULTRA LOW LATENCY INFRASTRUCTURE

FOR MARKET MAKERS AND ARBITRAGE TRADERS

TradFi **CeFi** **DeFi**

OUR CLIENTS



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Please note that from this quarter all sentiment data pertaining to outlooks over the next quarter will be published in a new industry-wide sentiment report that will be released in September.

Introduction

In this quarter's proprietary trading insight report, we start by casting an eye back on the first half of the year.

Assessing the challenges and successes of H1 and comparing the challenges to previous years, we also look at the regions and asset classes that have proved the most lucrative for proprietary trading firms and those which have disappointed.

In section two, we look at the implementation of AI and ML and examine how these technologies are being applied within prop trading firms.

We also take a deep-dive on Brazil, following on from our look at India last quarter. We look at how profitable the region has been for those who have deployed resources to it and where the key challenges of access have emerged.

In our hot topics this quarter, we cover European options market structure, the SEC broker-dealer rule and EU-UK divergence.

This report is based on a survey of the Acuiti Proprietary Trading Expert Network, a group of senior executives from prop trading firms across the global market.

Each quarter, members of the network suggest topics and questions to cover, which are then sent out to the network. If you are a senior proprietary trading executive who is not part of the network, please contact Alice at alicekristiansen@acuiti.io.

H1 in review: the year so far

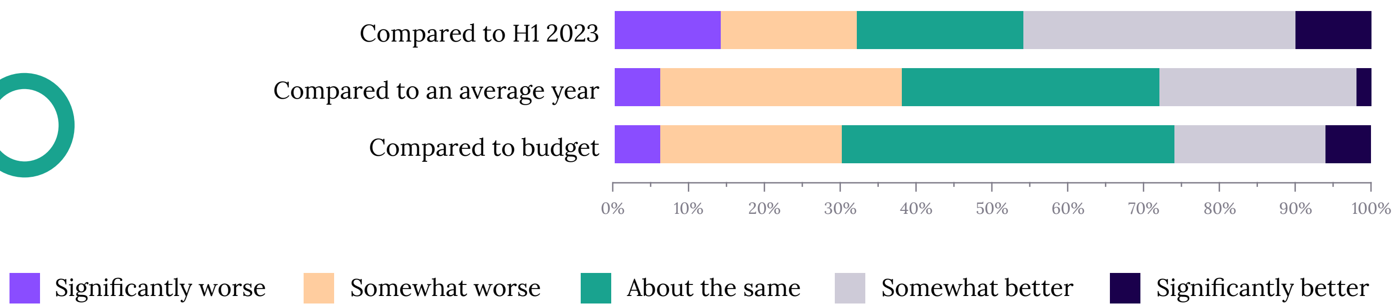
After the post-financial crisis dearth of opportunities for proprietary trading firms and the wider derivatives industry in the 2010s, the 2020s have provided some exceptional trading conditions.

After the booms of H1 2020 and H1 2022, however, the first six months of 2023 and 2024 have been relatively disappointing. This quarter's performance update found that proprietary trading firms have experienced mixed trading conditions in the first half of the year.

Compared to last year, a majority reported a better performance than in 2023. However, more network members thought the half had disappointed compared to an average year. A slightly higher proportion had come short of budget expectations than outperformed, although most had hit budget for H1.

This middling set of results reflects the relative lack of volatility in rates trading and equity markets, with market participants more certain that rate hikes have peaked and a mixed picture in equity markets that AI enthusiasm has obscured. As such, there has been a generally lower level of volatility in the market than compared to recent years. This was flagged as one of the biggest challenges faced by firms during H1 2024 (see next table).

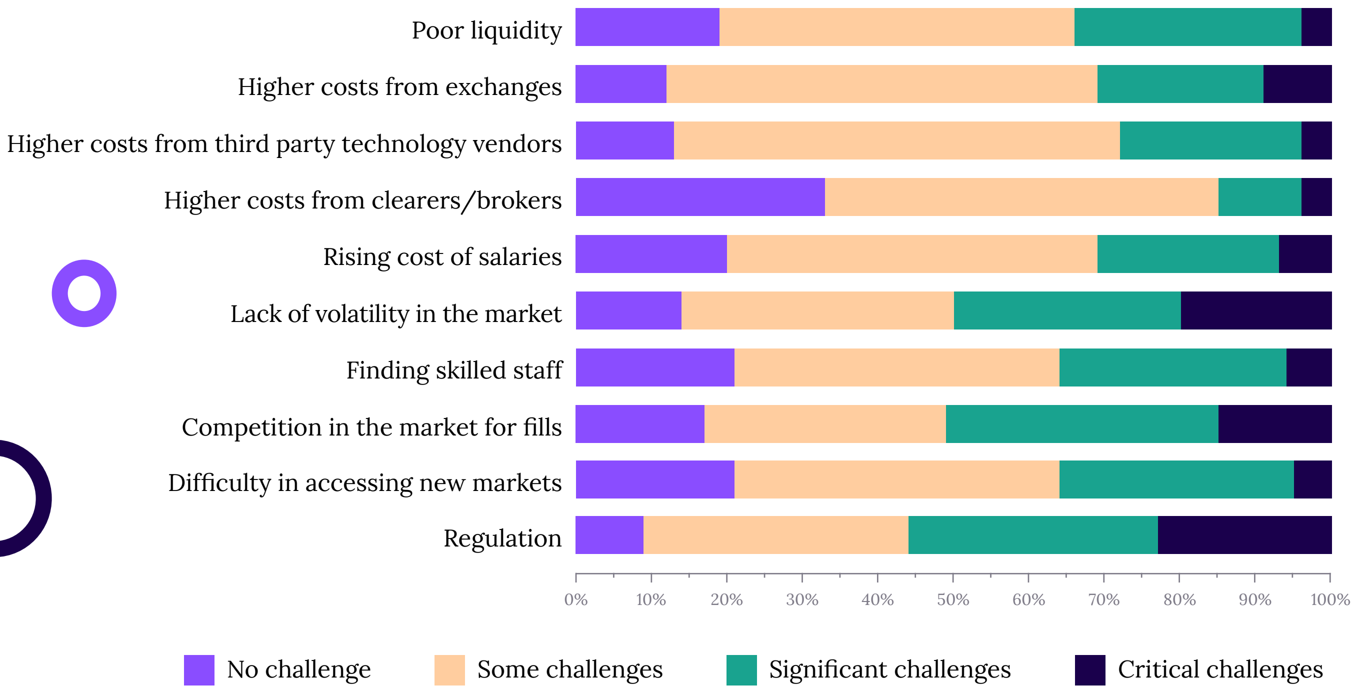
How has your business performed so far in the first half of 2024 relative to last year, an average year and what you expected/budgeted for?



The market conditions, however, favoured ultra-low latency and predominantly algorithmic firms over their peers. Almost 40% of these firms reported a better than average H1 compared with just 15% of firms with lower latency or more manual trading strategies.

Bucking a dominant run of good form over the past three years, almost 40% of US-based respondents reported a worse performance in H1 2024 than in an average year and no respondents reported a significantly better performance, bringing to an end a prolonged period of out-performance in the US.

During the first half of 2024, how much of a challenge have the following posed to your business?



Market conditions haven't been the only challenge firms have had to face in H1. Much of the drag on performance has come from the cost base, with regulation in particular adding to the burden. European firms were the most concerned by regulation, principally as a result of IFR/D and the significant compliance burden that it has imposed on firms (pushing some to relocate out of the continent).

Compared with H1 over the past two years, competition in the market has risen significantly. The amount of firms rating competition in the market for fills as a significant or critical challenge has nearly doubled in the past 12 months. Difficulty in accessing new markets has also risen as a challenge as firms look to emerging and frontier markets in the wake of increased competition and lower volatility in core domestic markets.

The challenges posed by higher costs have remained relatively flat across the last three years in the areas that Acuiti measures, with exchange and vendor cost increases rising faster than broker and clearing fees (see chart on next page).

% of respondents rating each challenge as significant or critical in H1 by year

Asset class performance

Assessing asset classes in the first half of the year, cryptocurrencies proved the most profitable for those that traded them. The market still faces challenges such as a lack of transparency and a disjointed and still nascent global regulatory framework. However, it has also received a significant boost from the approval of Bitcoin ETFs in the US (and preliminary approval of Ethereum ETFs) this year.

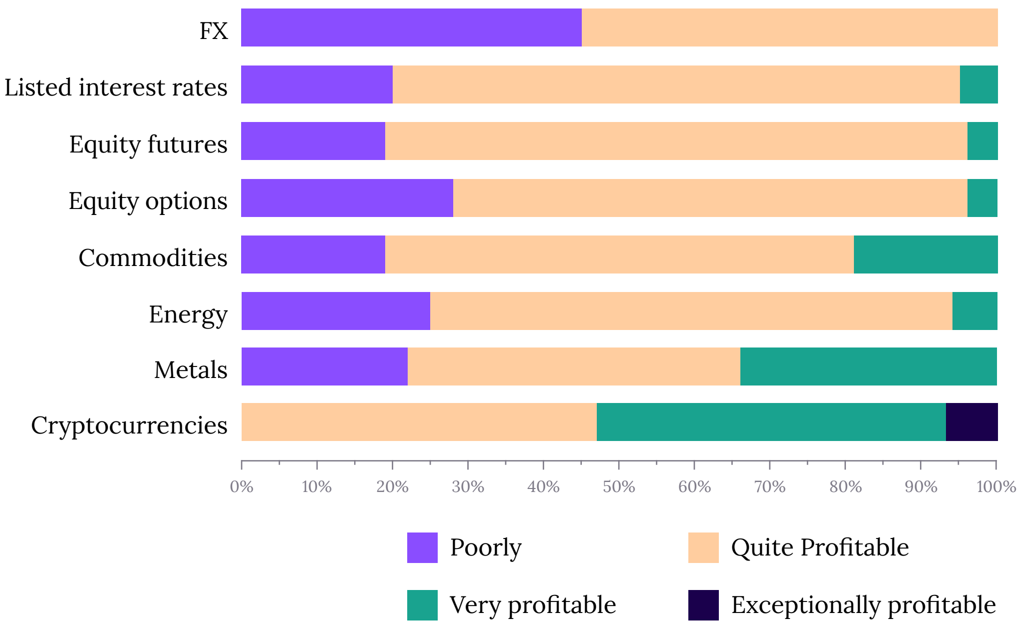
Commodities and metals also posted good returns. However, reports were more mixed on energy, listed interest rates and equity futures and options.

While most firms trading in these markets said they were relatively profitable, there were also several firms that had performed poorly.

After two years of volatility on the back of tightening monetary policy, the peak of central bank hiking has been hit in several key markets and expectations of multiple rates cuts have diminished during the year.

For equities, the surge in AI stocks has masked more tepid performance elsewhere.

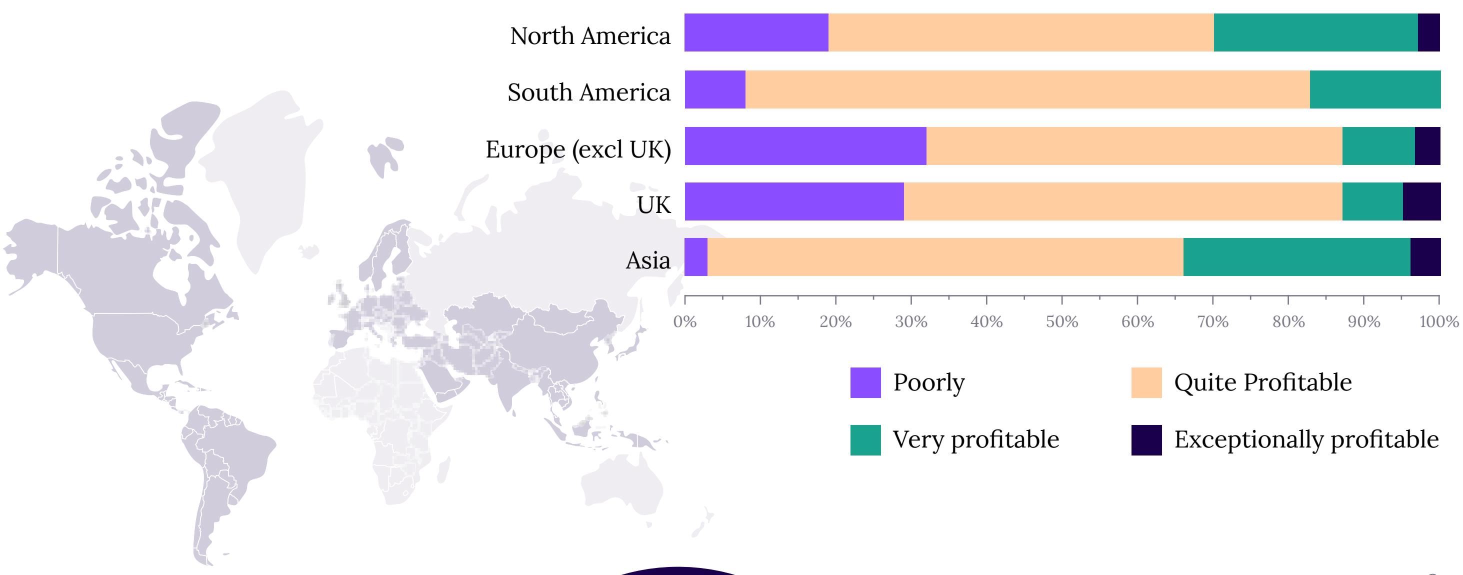
How did the following asset classes perform for your business in H1 2024?



Regionally, Asia was the most profitable, with a third of network members that traded on exchanges in the region reporting a very profitable or exceptionally profitable performance.

Interestingly, trading on exchanges in North America was more profitable for firms based outside the continent than those based in the US while firms trading on exchanges in Europe reported challenging conditions.

How did the following regions perform for your business in H1 2024 in terms of trading on exchanges in those regions?

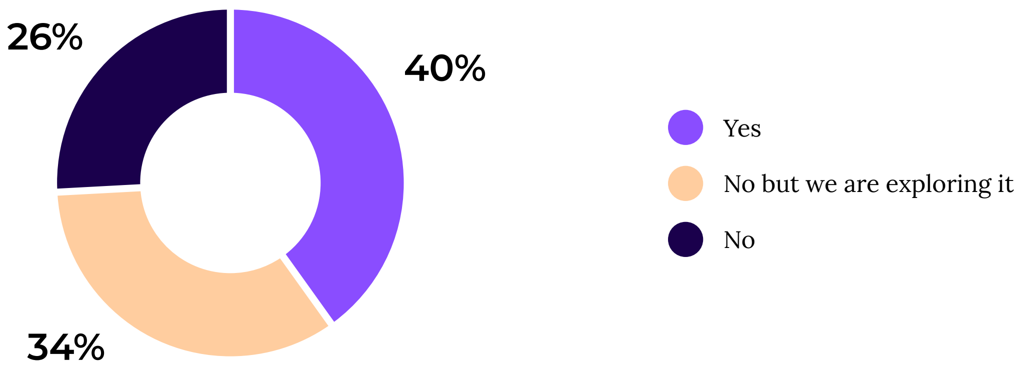


Section 2

The rise of AI

While Artificial Intelligence hit the mainstream in November 2022 with the launch of ChatGPT, cutting edge proprietary trading firms have been leveraging the technology for some time. and applications of AI and machine learing are growing. Two fifths of the network are already applying AI and/or ML to their operations. Overall, however, the move to AI/ML is slow, with just over a third only exploring use cases and about a quarter not engaging at all.

Does your firm deploy artificial intelligence/machine learning in any areas?

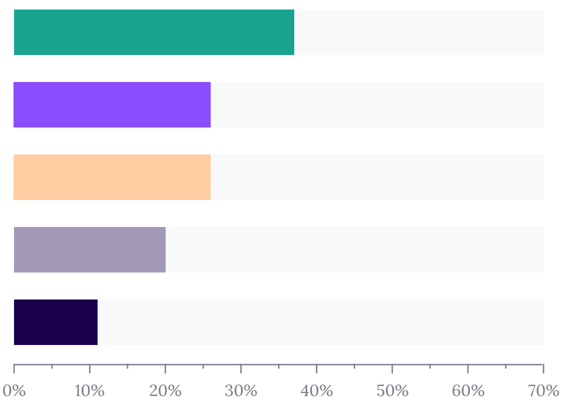


At present, more firms are using ML than AI. The most popular ML applications are in developing and executing trading strategies and surveillance. For AI, internal communications — such as building internal knowledge resources — was the most common application of the technology among proprietary trading firms so far.

Where are firms deploying AI or ML (ranked by most common applications of those firms that are using AI/ML)

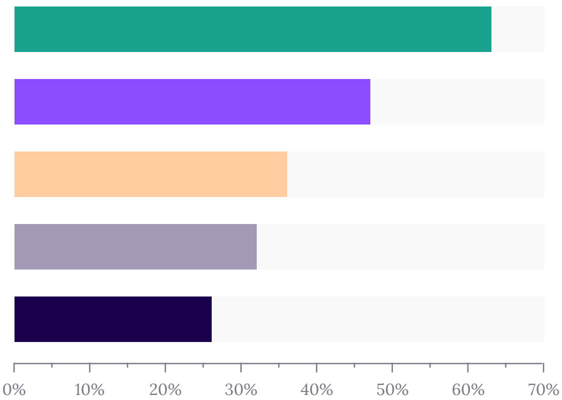
AI

1 Internal communications (37% deploying AI)
2 Surveillance (26%)
3 Developing trading strategies (26%)
4 Risk management (20%)
5 Executing trading strategies (11%)



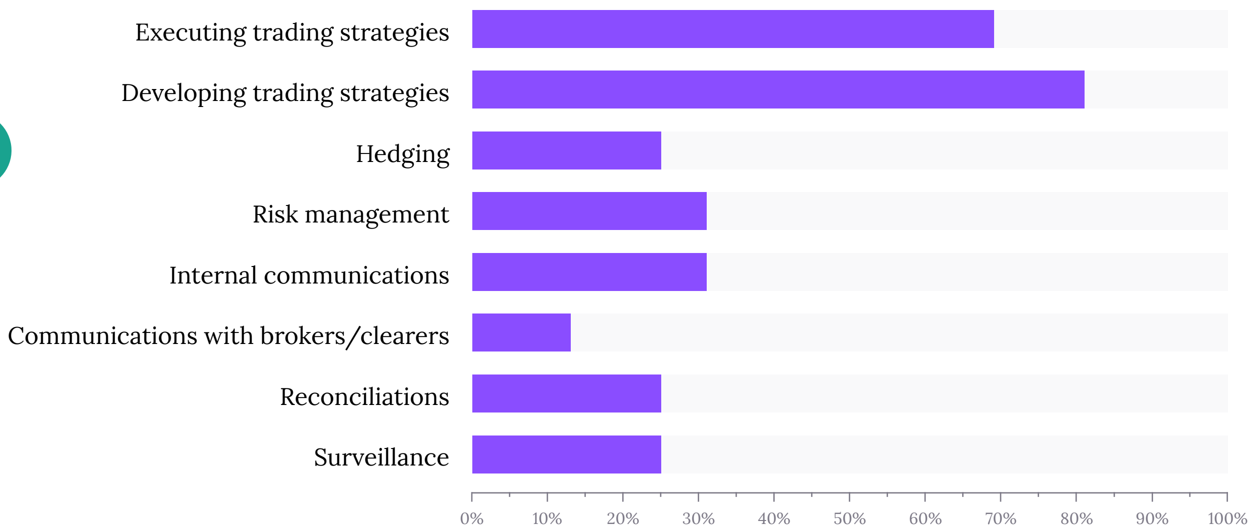
ML

1. Developing trading strategies (63%)
2. Executing trading strategies (47%)
3. Surveillance (36%)
4. Risk management (32%)
5. Hedging (26%)



Among those firms that were still planning how to apply AI and ML to their operations, developing and executing trading strategies were the areas of greatest focus. There was also notable attention on risk management.

In which areas are you considering deploying AI or ML?

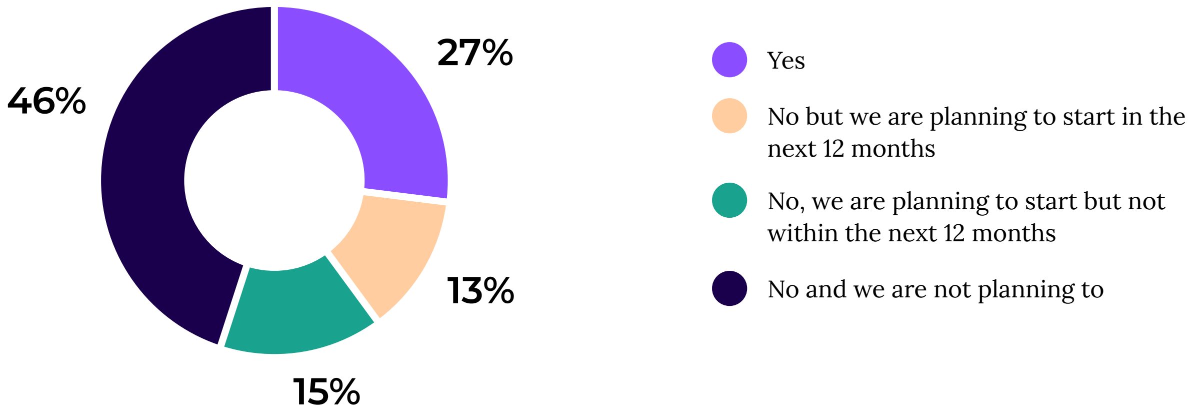


Section 3

Brazil

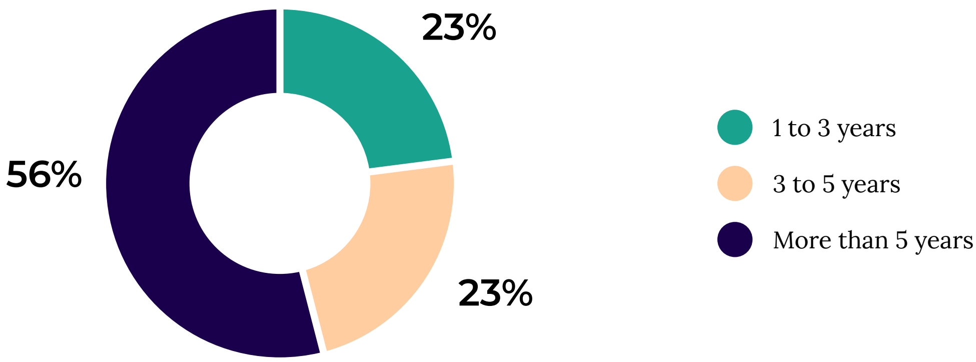
Over half of the firms in the network either trade or are planning to trade on B3 in Brazil, with the market having made significant efforts to court international sources of liquidity in recent years. More generally, the country's exposure consistently offers greater rates, FX and equity volatility than many developed markets.

Do you trade on B3 in Brazil?

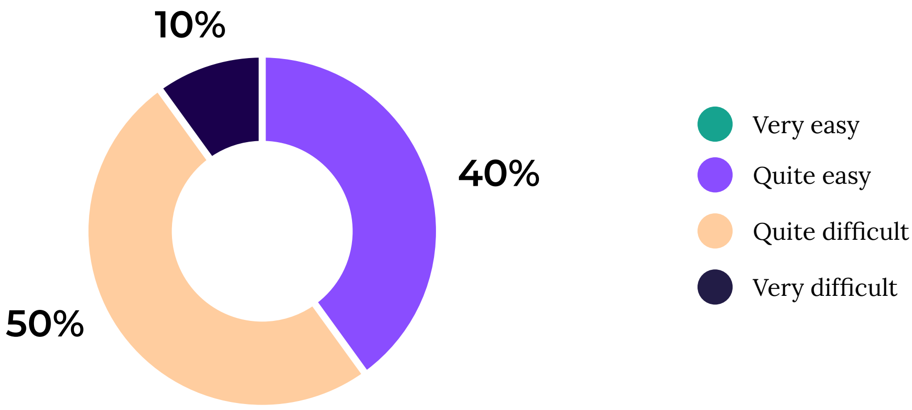


Among those that are already active on B3, most had been trading on the exchange for more than five years.

How long have you been trading on B3?



Overall, how easy was it to connect and start trading on B3?

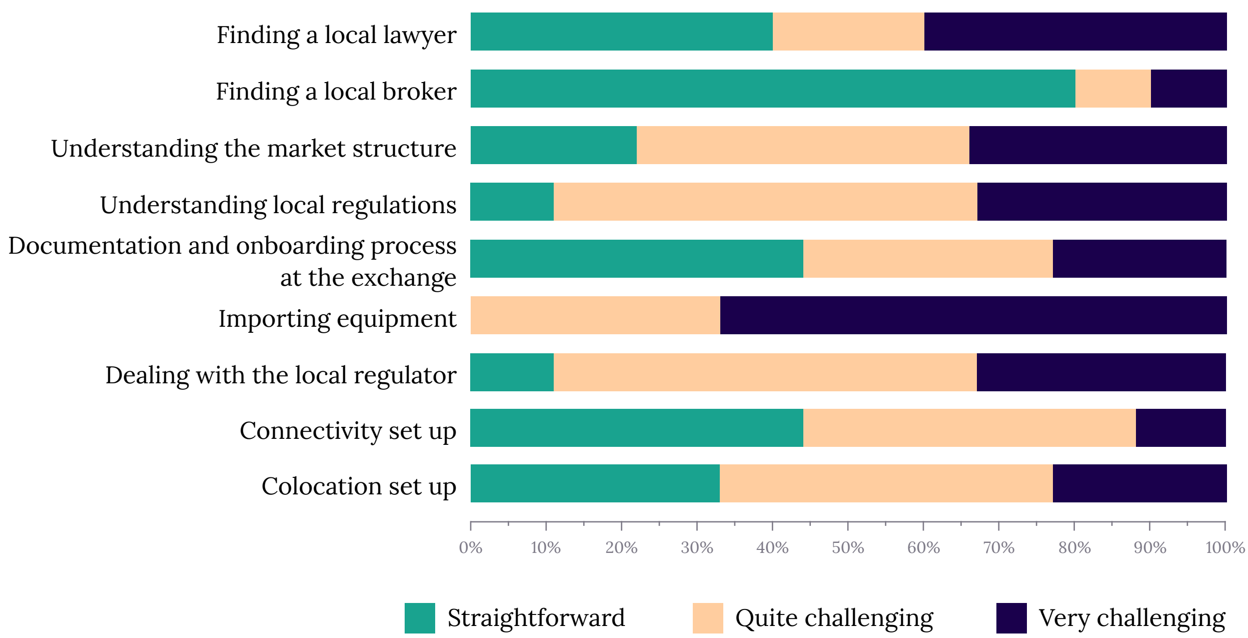


Compared to some emerging markets, operationally, B3 is a relatively easy exchange to connect to. Two-fifths of those trading on B3 said they had found it easy to do so, while half said it had been quite difficult. While the ease of access to B3 itself has been mostly smooth for firms, there are still operational complexities to trading in the country.

By far the greatest challenge identified by firms trading in Brazil was importing equipment, with Brazil's high import taxes making this a costly and also time-consuming task. Firms trying to import equipment risk facing long delays with customs processing.

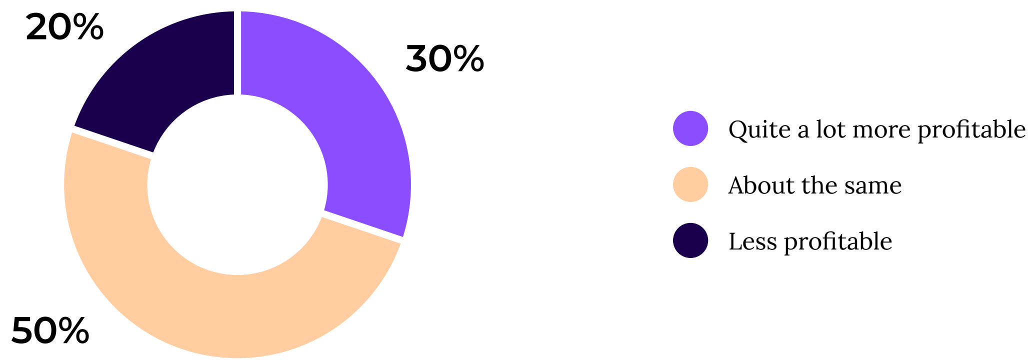
Firms also cited finding a local lawyer, understanding local regulations and dealing with the local regulator as significant challenges. In this instance both language barriers and the legal complexity of the Brazilian system (particularly as regards tax) can contribute to the challenge.

How challenging was the following when you started trading on B3?



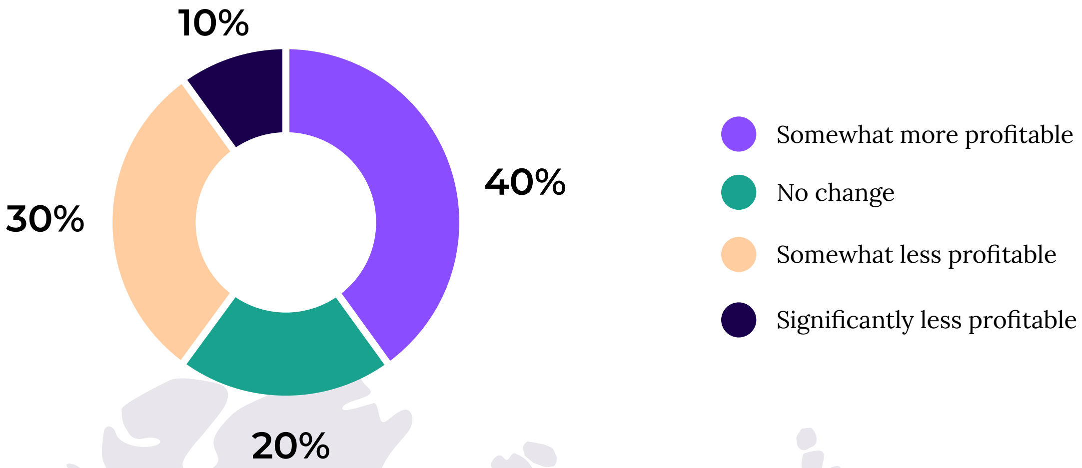
After overcoming those challenges, most were positive about the opportunity that Brazil offers as a market. About a third said B3 was quite a lot more profitable than an average market, while half said it offered about the same opportunity (see chart on next page).

Overall, how does the profitability of trading on B3 compare to an average market?



Two fifths said that trading on B3 had become more profitable during the time they had been trading, while the same proportion said it had become somewhat or significantly less profitable as more competition comes to the market.

Has trading on B3 become more of less profitable during the time you have been trading?



Hot Topics

Improving European options market structure

Europe's fragmented and costly options market structure has been a significant focus for many trading firms of late, and the subject of an Acuiti research report published earlier this year.

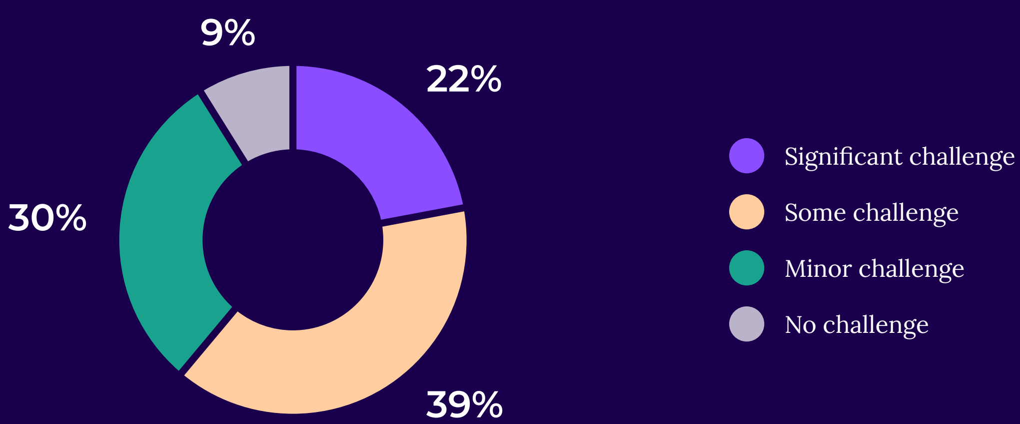
Many of the reasons for this are deeply embedded — such as fragmented liquidity and post-trade infrastructure across multiple CCPs.

Given the time and effort needed to make changes to these structures, some market participants have looked to smaller tweaks that could deliver faster improvements.

One of these is greater alignment between exchanges on expiry times and dates on contracts.

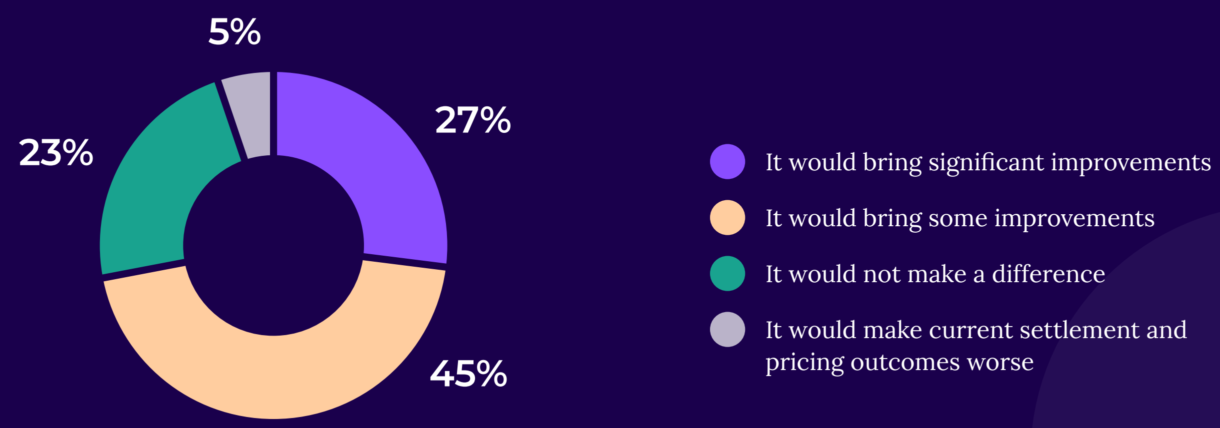
At present these vary significantly between exchanges and present a challenge to 61% of network members that trade in European markets.

How much of an operational burden do different expiry times / dates on contracts offered at different European derivatives exchanges cause for your firm?



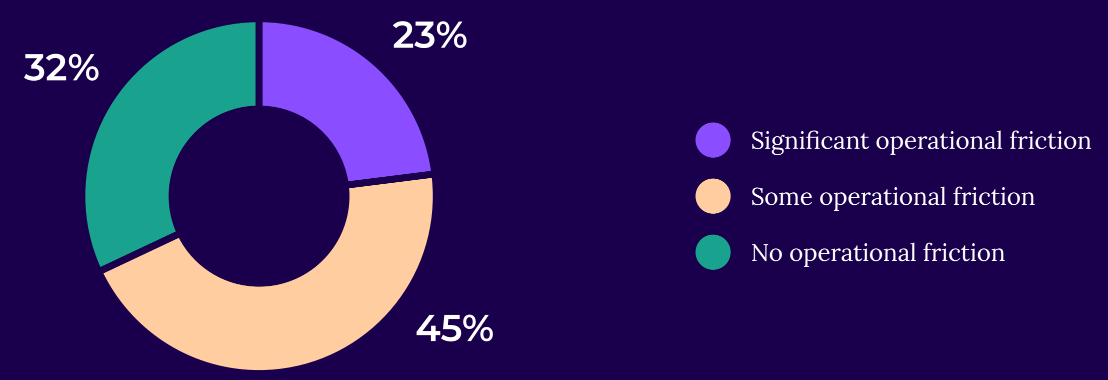
Over a quarter of network members said that greater cross-exchange alignment on expiry times would bring significant improvements to the market. Overall, 72% thought that this would improve the market.

How significantly would aligned expiry times across European exchanges improve the settlement and pricing of listed derivatives?



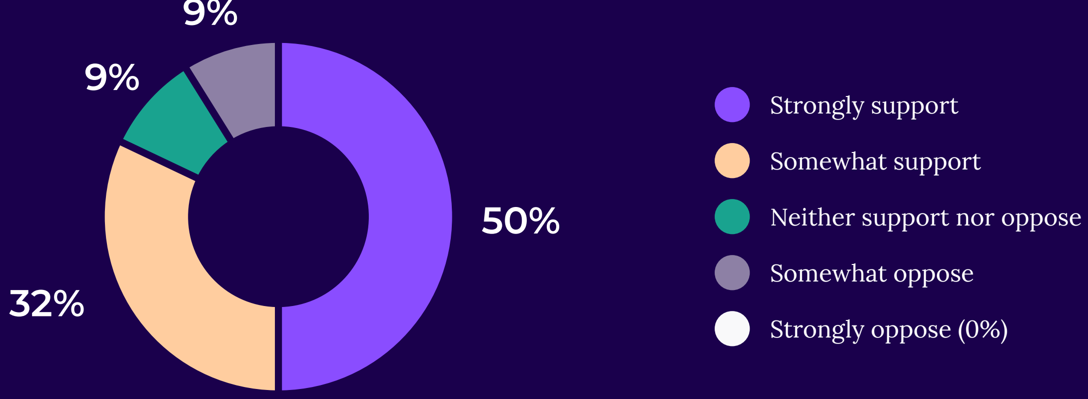
Another issue that network members have flagged is the different trading calendar and hours that European derivatives exchanges run. In the past this has seen Euronext open for a half day on December 31st, while Eurex was closed all day. For most of the network, this causes some operational friction.

How much friction does different trading hours and calendars at European derivatives exchanges cause to your firm?



Overall, 82% of the network support an aligned trading calendar across Europe, with half strongly supporting such a move.

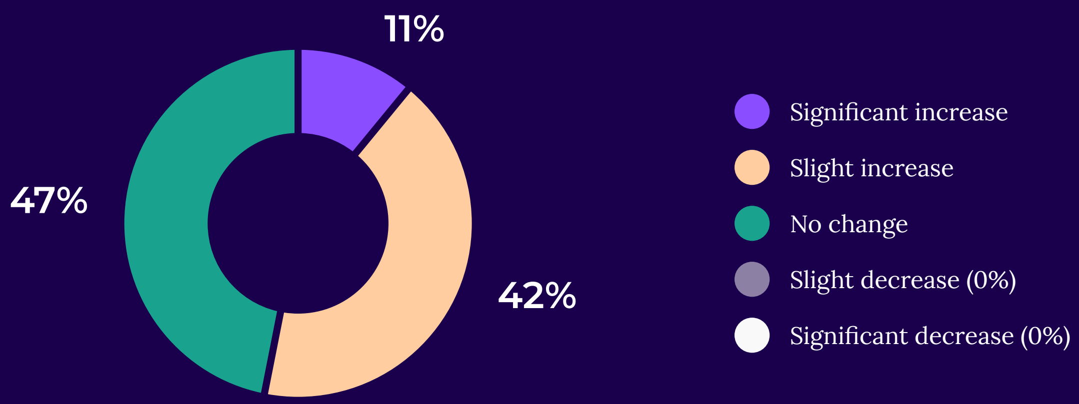
Would you support an aligned trading timeframe / calendar across Europe?



Margin costs

Overall, more than half the network has reported an increase in the cost of margin when trading options during the last 12 months. While most said this had been a slight increase, for 11% it has been significant.

How has the cost of margin when trading options changed for your firm over the past 12 months?



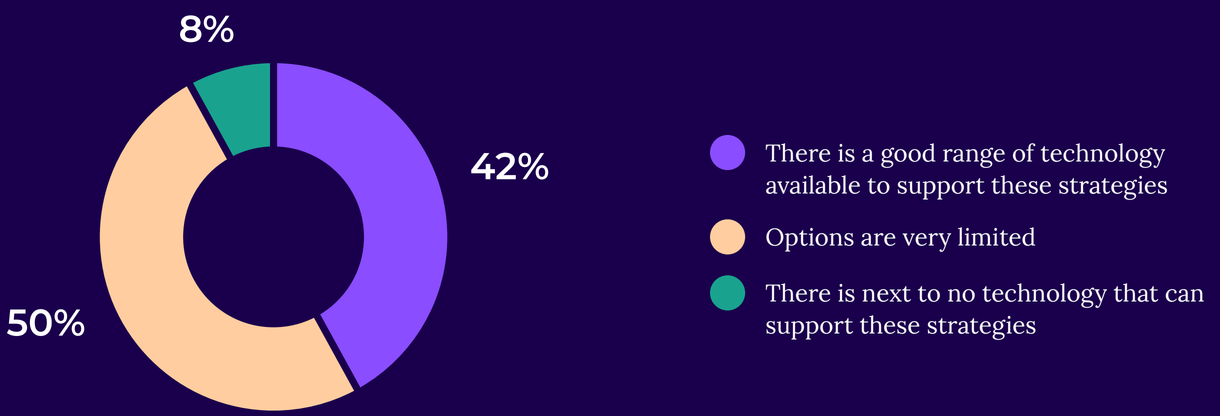
What impact has the increase in margin had on your trading?

The main reaction of proprietary trading firms to higher margin costs has been to adapt their strategies to be less margin intensive. Others also said they were trading less in certain products.

Commodity technology

Members who trade commodities have reported a lack of third-party software platforms to support trading strategies in more esoteric underlyings. Half of the network said that options were very limited in this regard, although just over two fifths said there was a good range of technology to support such strategies.

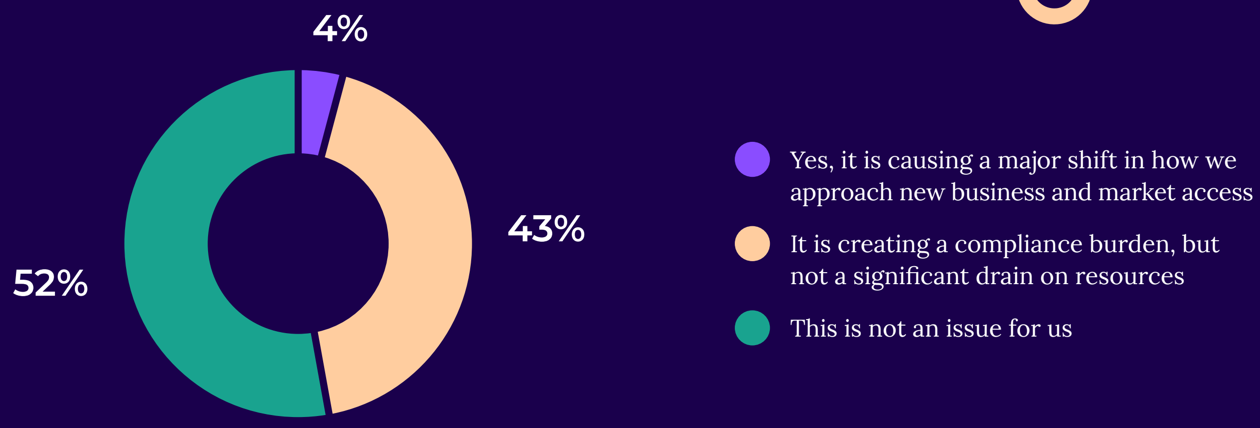
How well-served by third-party software providers are commodity trading strategies that incorporate spot and derivatives markets?



EU-UK divergence

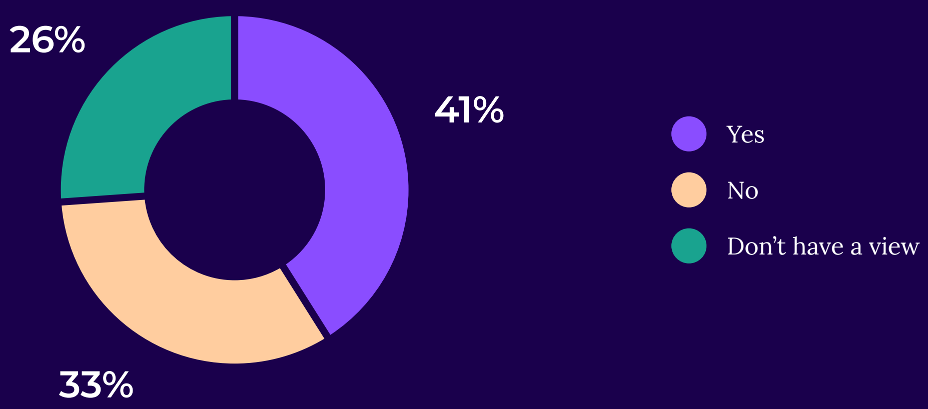
Another hot topic over the past two years since the UK left the EU has been EU-UK divergence on MiFID II and other rules. While there has not yet been major divergence between the two jurisdictions on this matter, some firms report that differences are emerging. Just over two fifths of the network members based in Europe reported a compliance burden arising from the difference, although the impact was limited at this stage.

Is EU- UK divergence on MiFID II an issue for your firm?



Despite the compliance burden, a greater proportion of the network supported greater divergence than were against it — perhaps a reflection of the negative impact of EU laws such as IFR/D and the belief that divergence will result in a better overall framework.

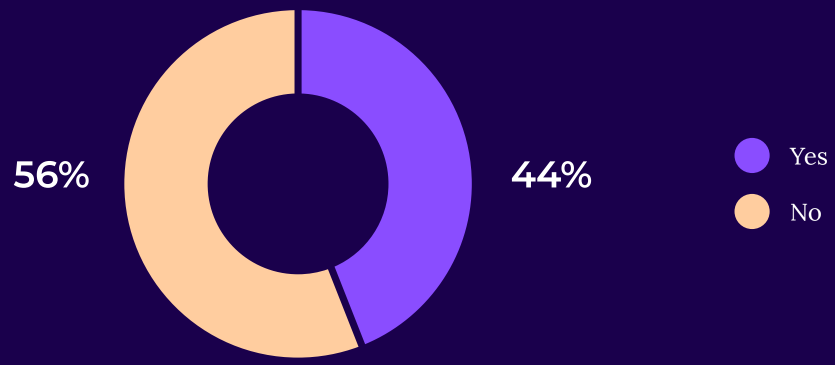
Would you support significant divergence in the UK from EU rules?



SEC broker-dealer expansion

The SEC's new rules expanding the definition of broker-dealer to cover more entities has attracted pushback from some corners of the trading community, particularly among hedge funds. Less explored is how this will affect prop trading firms. While most members of the network based in the US did not think they would be impacted by the rule, the margin was fine — with 44% coming into scope for it.

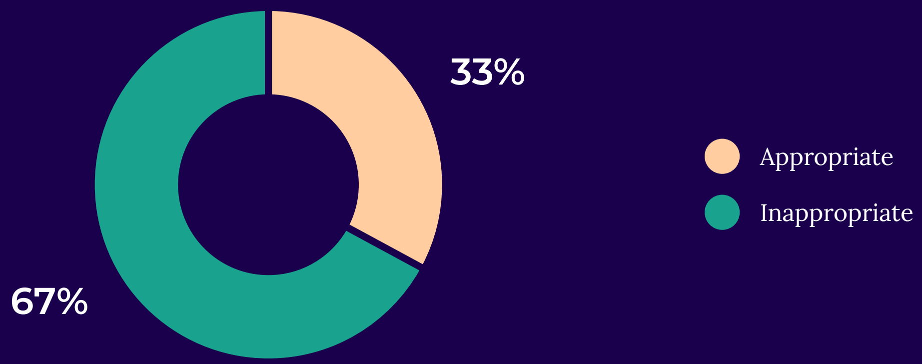
Are you impacted by the SEC broker-dealer rule?



All members who were coming under scope said they had identified which trading strategies would have to move to a broker-dealer model, although there were still some uncertainties to sort out.

However, none were planning to modify trading strategies as a workaround to avoid moving them into a broker-dealer. Most firms coming into scope thought that the broker-dealer rule was inappropriate for their firm.

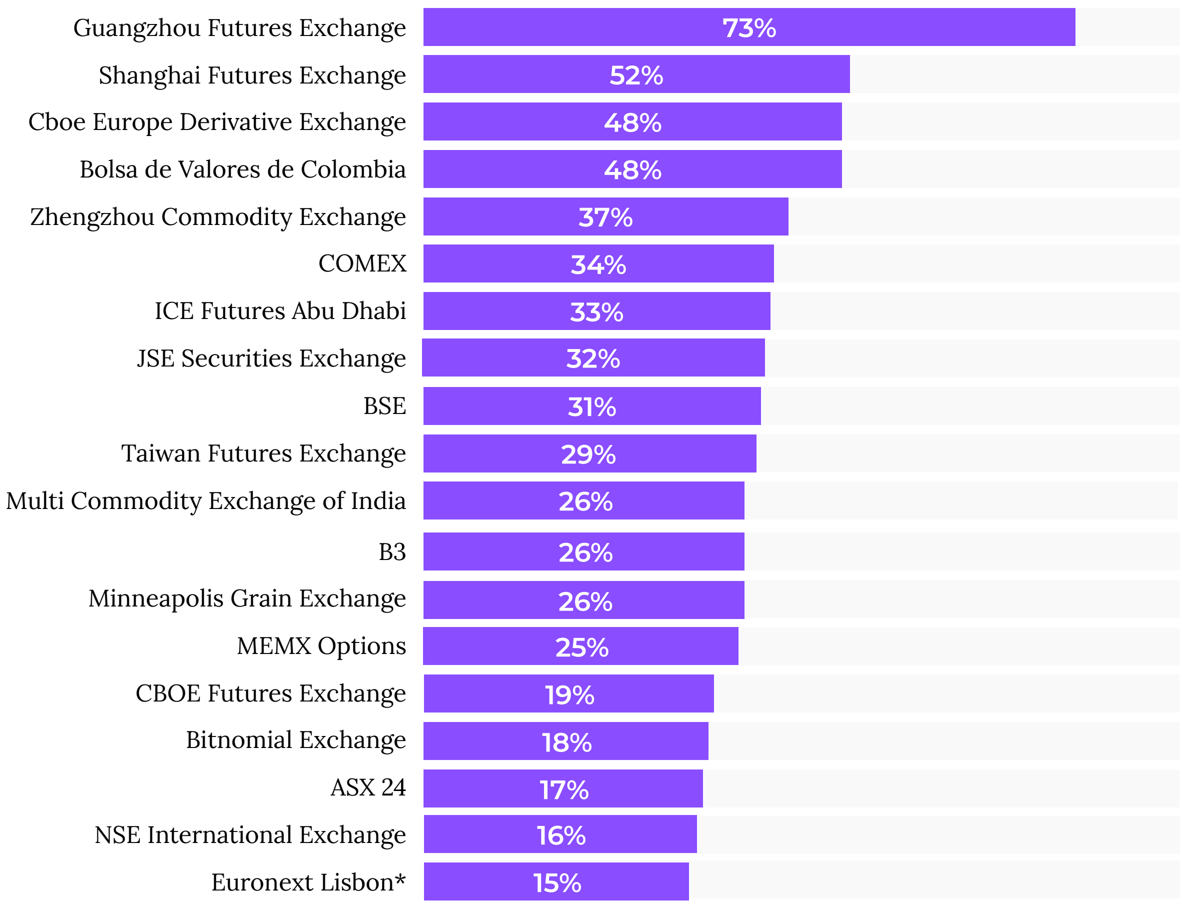
Do you think that the SEC Broker-Dealer Rule is appropriate for your firm?



Markets and 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 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
National Stock Exchange of India	Nifty Next 50	Option	5,012,632	223,416	83,543	24-Apr
Multi Commodity Exchange of India	Crude Oil Mini	Option	1,063,130	14,641	16,355	23-Apr
Multi Commodity Exchange of India	Natural Gas Mini	Option	772,127	8,328	11,878	23-Apr
Zhengzhou Commodity Exchange	Flat Glass	Option	140,450	25,887	3,511	21-Jun
Zhengzhou Commodity Exchange	Red Dates	Option	45,377	10,929	1,134	21-Jun
National Stock Exchange of India	Nifty Next 50	Futures	43,168	2,699	719	24-Apr
Coinbase Derivatives	Bitcoin Cash	Futures	30,287	2,583	480	01-Apr
Coinbase Derivatives	Dogecoin	Futures	27,264	2,987	432	29-Apr
Coinbase Derivatives	Litecoin	Futures	24,422	1,823	387	01-Apr
Coinbase Derivatives	Nano Crude Oil	Futures	23,602	295	575	03-Jun
Korea Exchange	Kosdaq Global Index	Futures	20,918	166	342	22-Apr
Coinbase Derivatives	Gold	Futures	9,578	206	233	03-Jun
Chicago Board of Trade	Bloomberg IG Credit	Futures	662	37	10	17-Jun
Chicago Board of Trade	Bloomberg HY Credit	Futures	398	72	6	17-Jun
Chicago Board of Trade	Bloomberg IG Duration-Hedged Credit	Futures	383	21	5	17-Jun

Source: FOW Data

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