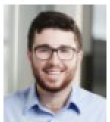
December 11, 2020

Forecast 2021: Electronic Trading & Market Structure Outlook, Part 1



Samuel Belden
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What were the trends in market structure and electronic trading this past year, and where are they headed? This edition of Forecast 2021 introduces movers and shakers in the market structure and trading space who offer their outlook for what's next for the industry, written by Sam Belden & staff at Forefront Communications.

The year 2020 has been unlike any other, and the capital markets and institutional fintech space were forced to adapt. In our Forecast 2021 series, we bring you reflections and predictions from prominent firms and thought leaders from the industry. Today, we're highlighting perspectives from the world of market structure and electronic trading, with thought leaders providing their perspectives on the spikes in volumes and volatility, the key trends that define electronic trading and the most consequential market structure changes looming on the horizon.

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Berenberg

A Hamburg-based Investment Bank

Jesse Forster, US Electronic Sales Trader, and Jason Rand, Global Head of Electronic Trading & Distribution

2020 saw major spikes in volumes and volatility. What was your experience during this period and what have been the long-term effects?

Jason Rand: Our experience was similar to most firms' – herculean efforts by our IT folks to get thousands of staff globally up and running remotely and ensure we were available to assist our clients in whatever capacity they needed us, whether that meant helping to source liquidity, consult on strategy selection, advise on performance measurement, etcetera. I think the industry overall -- both buy and sell side -- demonstrated remarkable resilience given the challenge of adapting to working from home. When we review this moment in history in the years to come, COVID may well be the "proof of concept" and catalyst the industry needed to achieve a better work/life balance after decades of drain on mental and physical well-being.

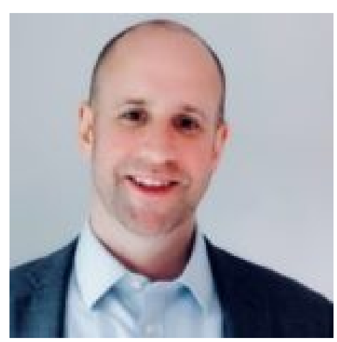
What's the most consequential market structure change you'd like to see made in the coming years?

Jason Rand: In Europe, although MiFID II has led to greater transparency and efficiency, there have been some unintended negative consequences resulting from aspects such as the dark liquidity caps, Best Execution requirements and the rollback of research requirements. To rectify them we think Europe would benefit from adopting the US approach of employing controlled and measured "Pilot Programs" designed to analyze the complexities and the benefits of proposals before they are born into legislation.

In the US, it's hard to narrow down a single change we'd like to see while the new NMS Plan around market data takes shape, but we'd like to see progress made on refining the Order Protection Rule. Exemptions for blocks and protection status for smaller venues (Nasdaq's 1.5% minimum market share requirement proposal seems fair) would be good places to start, in our opinion.

What are the most important trends in electronic trading to keep an eye on in 2021?

Jesse Forster: The speed arms race is over. We expect a continued push towards efficiencies and cost management through automation, significant investment into data architectures able to hone and gather the market- and trade-event data needed to make real-time trading decisions, and the continued investment in machine learning and artificial intelligence that is driving trade performance. We also anticipate big demand and increased innovation from Data-as-a-Service (DaaS) providers.



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Bloomberg
Global Data Provider and News Organization
Larry Tabb, Head of Market Structure Research

2020 saw major spikes in volumes and volatility. How do you think most firms handled it, and what do you think the long-term effects will be?

This was a very volatile year, as COVID-19 threw a monkey wrench into the idea that accommodating monetary policy floats all boats. COVID ran through the markets like it ran through the population, avoiding some like technology, and crippling others like leisure industries. This benefited brokers, exchanges and intermediaries as investors reacted. It also enabled the more astute stock pickers to do much better than their indices and for a time stay off the challenges of passive-based index investing. This market will continue to target different sectors until we have and can implement an effective virus strategy and the population can begin to live life normally.

It may take two or three years for not only everyone to be inoculated, but restaurants to reopen, people to travel again and hurt industry coffers to recover. While COVID has temporarily stayed the challenges of active management, I don't believe this will be a long-term rescue, as the fee differential between active and passive will, over time, continue to push investors toward lower fee strategies. Until active strategies can consistently outperform rival passive strategies at comparable costs, the major equity businesses will remain under pressure.

What are the most important trends in electronic trading to keep an eye on in 2021?

The most important electronic trading trends for 2021 will be: for equities, the increasing growth of algo analytics/algo wheels and the further automation of the buy-side trading desk. While outsourcing is gaining headlines, it won't make too much headway outside of smaller funds and niche use cases. That said, the bigger trends will be in Fixed Income, especially if the SEC continues their push to shape the bond markets. The big thing to keep an eye on is the SEC US Treasury proposals and if the Treasury market comes under the Exchange Act. If this occurs, we will see bonds take on a very similar trajectory to equities over the next decade.

What's the most consequential market structure change you'd like to see made in the coming years?

That I would like to see? I would like to see the SEC move forward with their market data infrastructure proposals. The most significant of which would be a change in governance for the SIP, leading to a distributed aggregated tape and a rethinking of odd lots. I think these three changes would make the market more efficient, lower the cost of market data, reduce payment for order flow and provide investors with better prices. That said, it could also eliminate zero commission retail brokerage, if payment for order flow is impacted too harshly.

The other thing I would like to see, but probably won't in my lifetime, is figuring out a way for the central banks to reduce their balance sheet and reverse the more than $7t in US central bank reserves it has pumped into the economy over the last decade. In the 40 years I have been in this industry risk has shifted from brokers as partnerships, to brokers as public entities, to brokers as banks, to now the central bank as the chief liquidity supplier and risk mitigator. While this has bolstered the economy, the industry and my retirement savings, I am not sure it's the best thing for the global economy.

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Healthy Markets
A coalition that promotes data-driven reforms to market structure
Tyler Gellasch, Executive Director

2020 saw major spikes in volumes and volatility. How do you think most firms handled it, and what do you think the long-term effects will be?

The takeaway should be that the circuit breakers, Regulation SCI and other measures established after the Flash Crash all seem to have worked about as well as could be expected. There were a few hiccups, of course, but I think regulators and the industry should be proud of the significant market infrastructure improvements and the markets functioned well. Looking forward, I think the big issues are going to be about valuations – and that's really a function of the economy and the Fed.

What are the most important trends in electronic trading to keep an eye on in 2021?

As for things within the industry, I expect the big 2021 evolution to be the continued rapid electronification of the fixed income markets, and integration between related assets. From the regulators, I expect there's going to be a lot of interest in continuing to better oversee ATSs for government securities, as well as improve the order routing and execution disclosure rules for equities.

What's the most consequential market structure change you'd like to see made in the coming years?

I think the SEC might pick up where Director Redfearn leaves off and keep going...on everything market structure. I think we might see an effort to directly tackle agency brokers' conflicts of interests (now that fee pilot is dead), as well as more on order routing and execution disclosures. And, of course, there's market data. I expect we may see the SEC work to better flesh out investment advisers' Best Execution responsibilities and improve funds' trading and research cost disclosures. That said, as we saw in 2008-2009 and this year, intervening events often have a way of derailing even the most planned agendas. No matter what, be on the lookout for action in fixed income market structure.

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HPR
A Capital Markets Infrastructure Vendor
Anthony Amicangioli, Co-Founder and CEO

2020 saw major spikes in volumes and volatility. What was your experience during this period and what have been the long-term effects?

As a key element of the market infrastructure, HPR needs to be prepared for anything. We saw unprecedented volumes in March trigger circuit breakers multiple times in the US markets. Our algorithmic clients continued sending orders during those periods, which HPR needed to stop. That amount of stopped order flow exceeded expectations, however we build systems to handle 10x the worst recorded day and will continue to do so.

What are the most important trends in electronic trading to keep an eye on in 2021?

Ever-increasing data volumes will continue to put pressure and strain on legacy trading infrastructure. The question is: how will the major hedge funds, brokers and exchanges adapt technologically? Also, as these market participants inevitably shift toward cloud/service-based architectures, public versus private cloud is still a key outstanding question.

What's the most consequential market structure change you'd like to see made in the coming years?

We believe that the continued regulatory support of free competition for market infrastructure is imperative. Allowing smaller, more nimble tech companies to deliver services such as the SIP feeds results in greater innovation, better performance and reduced costs.

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Old Mission

A quantitative market maker

Bryan Christian, Head of Business Development and Strategy

2020 saw major spikes in volumes and volatility. What was your experience during this period and what have been the long-term effects?

With few exceptions, the markets globally performed extremely well throughout the year. Clearly that was due in large part to the work of countless IT folks who helped virtually the entire industry begin working from home over the course of just a few days in March. But it's also a testament to the work that everyone in the capital markets ecosystem -- exchanges, broker-dealers, liquidity providers, investors, issuers, regulators, etcetera -- have done over the last decade-plus to prepare for this type of market event. Obviously, none of us should rest on our laurels, but I think the entire industry should be proud of how we helped millions and millions of investors worldwide efficiently manage their risk during conditions that only a few years ago could have been catastrophic.

What are the most important trends in electronic trading to keep an eye on in 2021?

Over the last several years, the buy side has been steadily creating the infrastructures needed to access additional sources of non-traditional liquidity. Those efforts paid clear dividends during the year, both in terms of transaction cost reduction and the efficiency with which they were able to transfer risk. We see this trend only accelerating as these new liquidity sources further develop across additional asset classes.

What's the most consequential market structure change you'd like to see made in the coming years?

We've seen a tremendous amount of AUM migrate from traditional mutual funds to ETFs over the last 18 months. Dimensional Fund Advisors' announcement last month that they'll be converting six of their mutual funds into ETFs next year was just the latest example, joining firms like T. Rowe Price, American Century, Fidelity and others who've done the same. The SEC's approval last year of the first crop of non-transparent ETFs has been a big driver of this shift, which we see as a major positive for the industry. We think ETFs provide a highly liquid and cost-effective way for investors to express their view of the market, and hope that regulators globally allow issuers worldwide to continue to innovate in this manner.

This article includes firms that are both clients and nonclients of Forefront Communications.

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Sam Belden *is an Account Executive at Forefront Communications, where he leads the firm's content efforts. He has written for a diverse group of firms including LiquidityBook, OpenFin, Security Traders Association, Tourmaline Partners and Xignite, and his work has appeared in numerous capital markets and fintech-focused publications. In a past life, he was a sportswriter whose work appeared on outlets including Business Insider, Golf.com and numerous baseball blogs. He is a graduate of Fordham University.*