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Top Market Structure Trends for 2021

Q1 2021

The subtle differences between Libor and SOFR open up interesting challenges and opportunities

3 new equity exchanges launched in 2020, while off-exchange trading grew

While 2020 is (thankfully) over, it is most certainly not forgotten. Without a doubt, 2020 brought with it the biggest set of market structure related events since the global credit crisis of 2008–2009. Every market was impacted, challenged and closely examined throughout the year, and these events will continue to be studied for the foreseeable future. While technology in general and electronic trading more specifically proved resilient in the midst of crazy market conditions, so too did the value of relationships between counterparties—all of whom were trying to survive the unpredictable market.

The year wasn't all about market structure, of course. There were huge macroeconomic, political and market events that also shaped the year: unemployment, a U.S. presidential election and volatile equity market prices. But market structure is what gets us most excited, so the ramifications of new equity exchanges, an increasingly tech-heavy fixed-income market, spending on surveillance technology, clearing, and continued cloud adoption are some of the big themes we see shaping 2021.

1 Market regulatory reform comes post-election and post-COVID—maybe

Historically, major market shocks have led to a slew of regulatory reforms. Remember Dodd-Frank? The same thing often happens when the party affiliation of the U.S. president changes. Bush to Obama and Obama to Trump both saw notable changes in the appetite for market oversight.

The SEC currently has a few irons in the fire, for instance: Reg NMS 2.0, the SIP revamp, bringing U.S. government bond trading venues under Reg ATS and SCI, and examining the regulatory framework for corporate and municipal bond electronic trading. Further, expectations of a Democratic SEC would suggest more rules, not fewer. The market shock of last spring brought only more scrutiny of these market structures, despite the robust performance of the technology that underpins them.

However, markets recovered almost as quickly as they collapsed (albeit with Fed intervention), and that quick recovery could make large-scale reform hard to justify.

2 Exchanges, trading venues and data providers have an identity crisis

Exchange is a very specific regulatory designation, but one that was usually synonymous with the designated firm—think NYSE or AMEX. While the regulatory designation still stands, the parent companies of the firms that hold those designations have gone through a wholesale change. Nasdaq identifies as a fintech firm. ICE, which owns NYSE among many other things, generated a third of its revenue from data in 2019. And LSE is poised to buy Refinitiv for $27 billion.

We also now have fixed-income trading venues that were once referred to as "ECNs," but now have market capitalizations that rival some of the oldest and largest exchange groups. MarketAxess has a market cap on par with Nasdaq, and Tradeweb's is bigger than Cboe's. However, both still generate the majority of their revenue from trading fees, with the data that they produce in the course of business only now making its value known.

An incredible network of market participants and unique data ties all of these firms together, although comparing them on an apples-to-apples basis is only set to get more complex.

3 SOFR isn't enough to replace Libor, and competition heats up for an alternative

Despite a slight reprieve in November 2020, Libor's decommissioning is still pushing forward. From a market structure perspective, the transition presents a unique challenge for the largest futures contract in the world—CME's eurodollar complex, which is pegged to Libor. The eurodollar futures contract achieved its dominant position because Libor represented the standard bank funding rate: three-month term unsecured (the interest rate on a three-month uncollateralized loan).

Naturally, then, bank clients pay a spread on this rate that the banks capture as revenue. Thus, the standard term for funding costs was "Libor plus x." After the financial crisis, money center banks switched to funding "overnight secured" in the repo markets (the interest rate on a overnight collateralized loan)—the rate that SOFR tracks. CME has also amassed the market dominant position in futures contracts tracking SOFR.

The subtle differences between these rates—term unsecured and overnight secured—opens up interesting challenges and opportunities. AFX, ICE and Bloomberg all have alternatives to the alternative (SOFR). With trillions of dollars in futures open interest and swaps tied to Libor at stake, the race to be ***the*** benchmark is sure to heat up.

4 Credit market electronification is redefined and becomes more diverse

Despite a return to the phone in March of 2020, corporate bond electronic trading grew year over year and now accounts for over one-third of investment-grade volume—and there is certainly more room to run. Platform valuations and buy-side enthusiasm over new protocols and data-driven trading tools point to only more trading on the screen going forward.

However, we have entered a period in which most of the low-hanging fruit has been picked and generating more onscreen activity will require market participant interactions that are different than what we might have traditionally viewed as electronic. We proposed a set of definitions for corporate bond trades, including these new methods, last fall. Hence, the market's mentality will shift from a purely electronic trading focus to a much broader focus on digitization. What does that mean? Technology will bring efficiency beyond the matching of buyers and sellers and will streamline pre-, at- and post-trade activities, even in products that are bespoke, illiquid, hard to price, or all of the above.

5 Equity traders demonstrate an appetite for new exchanges and order types

Three new equity exchanges launched in Q3 2020: the Long-Term Stock Exchange (LTSE), the Members Exchange (MEMX) and the Miami Pearl Equities Exchange (MIAX Equities). Each of the three has a different focus. LTSE wants to change the nature of the listing business away from the short-term profit driven model. MEMX is reviving a broad-based ownership model in the exchange space built on leading-edge tech. MIAX looks to repeat its success on its "jump ball" formula used in the options space to drive volume in the equity realm. Early indications tell us that the market does, in fact, have an appetite for something new. But of course, the combined average daily volume of the upstarts remains well below 1%, leaving the incumbents still in their market-leading position.

In addition, we continue to see an increase in the move toward off-exchange trading on the Trade Reporting Facility (TRF). This not only follows the massive spike in retail trading (and resulting increased internalization of retail order flow), but also highlights other trading systems and functionality offered by brokers and alternative trading systems (ATSs).

The evolution of functionality away from strict price/time priority (and its attendant drive toward diminishing returns on latency gains) has allowed for these non-exchange systems to flourish. Block trading systems, guaranteed market-on-close (GMOC) offerings, conditional orders, and alternative AI matching systems all continue to rise in importance, as the industry increasingly looks to find liquidity where it has the least market impact. Further, Cboe's acquisition of BIDS opens a new realm of possibilities in which exchanges are likely to seek market share via bringing dark venues under their umbrella.

6 Options trading venues fight even harder to capture increasing demand

2020 was a blowout year for the U.S.-listed options industry. The combination of huge volatility spikes, the move to zero commissions, the launch of retail options trading apps, and the failure of traditional hedges drove a massive increase in option volumes. This was specifically true in single-name options. While trading volumes in most financial instruments declined after the government intervention calmed markets in the spring, single-stock listed options volume kept on growing. Some of this was story-driven, like TSLA's stock split or the "Nasdaq Whale" (aka SoftBank), but this feels more structural than cyclical.

There are today over a dozen listed options exchanges, but they are contained within four exchange groups. Now that MIAX has decided to enter the stock exchange business, it seems even more likely that the remaining stock exchanges that do not have options exchanges—MEMX and IEX, for example—might try to set them up. The technological lift is small and the market share necessary to reach profitability is even less, now that marketwide volumes are so much higher. Additional market structure innovations are likely: DASH's ATS, for instance, or the revival of options dark pools.

7 CLOB and nonbank market makers grow in FX, as participants focus on settlement risk and credit intermediation

Our research in 2020 examined the effects of the COVID crisis on algo and TCA usage in FX markets, but the market's focus on credit intermediation and settlement risk could ultimately prove to be a more impactful change. Both are critical elements of FX market structure, and although continuous linked settlement (CLS) exists for the largest dealers, other firms are working toward new solutions to minimize settlement and credit risk.

There are two main drivers behind that effort. First is the imminence of the Uncleared Margin Rules (UMR) implementation, still on the horizon despite a COVID-related delay. Deliverable FX swaps, the largest single FX instruments by volume, are exempt from the initial margin requirement but do count toward the determination of whether a firm is in scope (or not). This means that some firms may look to avoid punitive IM requirements by clearing their FX swaps in an effort to fall out of scope. Additionally, ECNs require credit intermediation for nonbanks to access them, and non-dealer market makers remained bedeviled by credit limits. Firms like LCH and Capitolis are innovating here, but the overall inertia toward change warrants watching.

8 Communication and collaboration technologies, along with the tools to surveil them, continue their incredible expansion

While the last year proved that people can collaborate and communicate even while apart, it also proved that oversight of these interactions was lacking. In the ensuing rush to patch these holes, technology dollars were quickly reallocated across vendor offerings and internally built systems. Efforts to shore up this now-crucial part of compliance infrastructure will continue throughout 2021.

Use of encrypted platforms such as WhatsApp, which came under regulatory scrutiny and media spotlight in 2020, will continue to be a controversial topic in compliance policy reviews and a driver of monitoring technology development and adoption. Third-party solutions providers will continue to expanded coverage capabilities of these and other challenging communication channels, such as video conferencing, and some upper-tier banks have launched efforts to develop internally built substitutes to the currently available communication platforms. Many compliance departments will also further holistic surveillance efforts by prioritizing integration of surveillance alert generation and investigations.

As compliance departments get more comfortable, electronic collaboration tools will only grow in use and in value. The competition among them—both the financial service-specific solutions and those used by a broader audience—will ultimately benefit all consumers, as innovative new features and functions will hit desktops and tablets faster than we can use them.

9 Cloud computing keeps growing, as banks spend money to save money

Cloud computing obviously isn't a new story in capital markets. In fact, we've pointed to it as a trend to watch in past years. But as banks and others in the market increasingly look to do more with less, cloud computing and the services that use it have evolved to where they can impact both sides of that goal, increasing profitability and reducing costs.

Over the years, our research has talked about the importance of finding alternative and other unique data sources. The story now, however, is about putting that data to work. Only cloud computing offers the storage and compute power needed to find an edge in a jumbled mess of unstructured data. The cost reduction story is arguably more compelling. Maintaining increasingly complex risk management and trading systems is generally easier when they are cloud-deployed rather than locally installed. Ensuring data consistency across those systems can also be costly, both in terms of process and potential losses from incorrect information. Cloud has proven it can help ease both of those pain points.

Greater use of public cloud and hybrid approaches is likely in this pursuit, as banks seek to unify market data for front-office and risk purposes and revamp their central data layers, as data quality for market risk rises to the forefront.

10 Regulators and the market become more comfortable with tokenized assets

The journey of digital assets to institutional acceptance is finally getting somewhere. The rise of tokenized assets tied to registered securities thus far serves as a sign of things to come. As such, security tokens should have a breakout year in 2021, with firms seeking to solve for the top two challenges: regulatory certainty and secondary market liquidity. That will drive continued creation and adoption of platforms for trading, custody and derivatives, including brand new ATSs.

This momentum should also bring an acceleration of regulatory acceptance. Last year in the U.K., the FCA gave a license to Archax to be the first digital securities exchange—another sign of things to come. Regulatory acceptance is not only about the assets themselves, but also about the different services across the value chain, such as custody, settlement, issuance, and trading needed to power a real market forward.

If these stars all continue to align, 2021 is shaping up to be the year in which traditional securities and blockchains actually start to converge.

11 Retail customers continue to trade (mostly) for free, driving more wealth management consolidation

We all knew zero-commission trading would be a boon for retail traders in 2020, but never like this. (Mostly) free trading in ETFs and the hot stocks of the moment (TSLA anyone?), coupled with market volatility, gave retail investors a new voice, and the industry that services them will have to react.

The Schwab and TD merger is a harbinger of consolidation in the distribution channel, for instance, and as advisors continue to migrate toward fee-based relationships, consolidation is one way to counteract worsening economics. In addition, fund complexes will continue to seek their own efficiency gains, as institutional fund companies merge with each other, such as Morgan Stanley's acquisition of Eaton Vance. And lastly, new digital offerings allow advisors to serve small clients efficiently, while still focusing on wealthier clients with higher-value services, such as custom portfolios—something else set to grow in the months ahead.

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