Optiver

Insights

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Market Regulation

Why trade execution still matters

UK and EU regulators are set to reverse historic 'unbundling' rules. But while the rules were imperfect, we believe real strides were made in getting investors to pay attention to trading costs. Now more than ever, traders need to carefully choose the right execution partners and strategy.

When European financial regulators passed rules forcing brokers to separate charges for research and execution in 2018, a backlash was inevitable. Among other predictions, critics anticipated shrinking research coverage of small- and mid-cap companies and a race to the bottom in research fees as large banks sought to retain market share.

Six years on from MiFID II, UK and EU regulators are set to reverse historic 'unbundling' rules. The reasons are somewhat predictable: fears of a declining research market and regulatory conflicts that have created barriers for European companies wishing to buy research from US firms.

But while the rules were imperfect, we believe real strides were made in getting investors to pay attention to trading costs, progress we should fight to keep. With more options than ever for managing their execution process, today's trading desks should continue to carefully scrutinise their execution partners and analyse implicit trading costs.

In our recent survey of over 200 buy-side firms, the majority of respondents identified improved trade execution analytics – a key aim of unbundling – as a top priority. Meanwhile, the CEO of the British asset management giant Schroders has come out saying that his firm won't rebundle, but will continue to pay research costs separately from trading commissions.

"The genie is out of the bottle," he told Financial News back in March.

Separating execution from research

By forcing brokers to charge separately for research and execution, unbundling was designed to help the buy-side see more clearly what they were paying to trade. It was also intended to prevent banks from winning execution flow purely on the strength and breadth of their research offering.

These were fundamental, sweeping changes to long-standing trading arrangements – so it wasn't surprising that they ruffled feathers and caused concern.

While the reviews have been mixed, EU and UK regulators initially found these fears overblown. In separate reviews shortly after the rules were introduced the European Securities and Markets

Authority and the UK's Financial Conduct Authority saw no significant decline in research quality or supply.

Equally important, the rules were having their intended effect on trading. The FCA found that "several firms [had reassessed] their use of high-cost versus low-cost execution channels, eg electronic and algorithmic trading, [which] resulted in them making more use of lower cost channels, and further client cost savings."

Now more than ever, we feel this trend is worth preserving. Modern equity market structure – characterised by dozens of markets, each with their own pricing, mix of participants and matching logic – requires traders to carefully choose the right execution partners and strategy, something that unbundling promotes.

Norges Bank Investment Management, the world's largest equity investor, devoted several pages in a recent report to arguing for the importance of trade execution. While acknowledging that "it was uncommon for asset managers to measure execution results" when the firm started investing in 2001 – with the bulk of trading concentrated on national exchanges – liquidity fragmentation and technology has made this more widespread.

Despite these sentiments, there is still a danger that the industry slips back into its old ways. It's possible, for example, that one large firm could take a cue from regulators and break ranks, inspiring others to piggyback on this move. We could also see a gradual approach, where some firms use bundled commissions for mid- or small-cap funds, where research is more scarce and can act as a loss leader.

Unbundling may soon be consigned to history but we urge the industry not to lose sight of what the spirit of these rules offered to end investors.

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About Optiver

Optiver is a global market maker founded in Amsterdam, with offices in London, Chicago, Austin, New York, Sydney, Shanghai, Hong Kong, Singapore, Taipei and Mumbai. Established in 1986, today we are a leading liquidity provider, with close to 2,000 employees in offices around the world, united in our commitment to improve the market through competitive pricing, execution and risk management. By providing liquidity on multiple exchanges across the world in various financial instruments we participate in the safeguarding of healthy and efficient markets. We provide liquidity to financial markets using our own capital, at our own risk, trading a wide range of products: listed derivatives, cash equities, ETFs, bonds and foreign currencies.