MiFID II and Evolving Equity Execution

With Societe Generale Prime Services' Francois Banneville

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Fragmentation of equity market microstructure and liquidity has manifested in a near doubling of trading venues from 17 in 2007 to 30 a decade later, while average ticket sizes have been divided by seven, dropping from EUR 28-30,000 to EUR 4-5,000 over the same period. The increased complexity of navigating these markets has forced asset managers to raise their game. "Execution efficiency is a cost of doing business and it is getting harder and harder not to invest a lot of money," says Francois Banneville, Societe Generale's Prime Services Head of Execution, who has seen most of his clients reorganise their desks over the past two years. There have been two key trends. "One big theme was trading across asset classes. Another was trading electronically, partly to manage costs and increase the STP rate, but also to tackle more efficiently the evolving market microstructure," he notes.

Against this backdrop, Societe Generale Prime Services has also seen its share of organisational change, starting with the acquisition and integration of Newedge into Prime Services in 2015, which THFJ covered. "We made a positive, bold, early move in acquiring Newedge. They are passionate about what they do and a leader in Listed Derivatives Clearing and Execution which complemented our Cash Equity business," Banneville says. Initially, high touch equity execution was kept close to research but now, as Banneville points out, "MiFID II requires a complete decoupling of research and execution, not just unbundling. So, we have regrouped all cross-asset listed agency execution (high touch and low touch) under one roof, to present an even more comprehensive, integrated and holistic offering." The global cross-asset execution team of 180 includes around 50 in the US hubs (New York, Chicago), 50 in London, 45 in Paris and satellite offices of Frankfurt, Madrid and Zurich, and 35 in APAC spread across Hong Kong, Sydney, Tokyo, Mumbai, Seoul and Taipei.

Multi-asset class, real time, IT infrastructure

This global franchise spans all asset classes and demands that IT systems keep pace. Societe Generale Prime Services spent almost a year carrying out a beauty parade of six or seven risk software providers. "We wanted consistency between intraday and end of day P&L and risk metrics and across asset classes," explains Pascal Marciano, COO Prime Services Risk. (This is partly to avoid false alarms over margin calls that can arise from asynchronous systems). Imagine met SG's criteria: "It really is real time and integrates calculations across all asset classes. Every time futures are cleared, or equities or Portfolio Swaps are traded, they feed immediately into Imagine, which instantly updates the VaR, greeks, threshold alerts etc.," explains Didier Livio, Global Head of Prime Services Risk. SG partnered with Imagine to customise the system in ways that other Imagine clients now benefit from. The implementation and internal validation process took two years and is approaching completion with global roll out in US, Europe and Asia. A current project is customised margining around cross-margining, netting and offsets. The next step is giving SG clients access to an Imagine interface (whether or not they are themselves clients of Imagine).

A wide client base has been drawn to the breadth of the Societe Generale Prime Services offering, which includes clearing, financing (through swaps, security loans, margin lending, repoes and synthetic means such as Portfolio Swaps and TRS), security lending, collateral transformation and execution, OTC clearing and FCM services, as we detailed in our 2015 profile. Societe Generale Prime Services has always been renowned for its CTA and macro franchise and is now growing its presence in equities. The equity roster includes clients trading more traditional long/short equity funds, quantitative strategies and those trading both cash and synthetic equities.

Integrated equity execution: high, mid and low touch

In equities, Banneville's unit has huge coverage of listed markets and he does not underestimate the costs of having obtained this, in terms of developing execution systems, settlement processes and clearing processes. SG's market share is around 4-5% on most European equity exchanges, while it is the largest in listed derivatives on CME Group with 17.5%. Listed volatility futures, such as the VIX and dividend-adjusted equity futures, are part of the suite (elsewhere in Societe Generale Prime Services, OTC derivatives such as dividend swaps and variance swaps are also traded).

Societe Generale Prime Services offers three main execution channels for cash equities and listed derivatives: high touch (voice), low touch (electronic including DMA algorithms) and mid touch (program trading). Banneville points out that they "are large enough to be global but small enough to be nimble and integrated without siloes. Clients can choose one point of contact for coverage, or many specialists from our cross-region and asset class matrix."

The integration of high and low touch activity does not imply any automatic sharing of information between them and indeed, electronic order flow is by design segregated from voice flow. "It is paramount that the teams do not have access to the same books," explains Banneville. Confidentiality is so important for some clients, including certain quantitative funds and those focused on latency, that they are only referred to internally by designated code names." On the other hand, certain clients give Societe Generale Prime Services permission to selectively advertise part or all of their order flow. They can even specify precise instructions on where the information can, and cannot, be disseminated.

Societe Generale Prime Services is agnostic on whether clients are using cash or non-cash instruments and if they execute electronically or not. Some clients are 100% electronic and all trade something electronically. Around 70% of equity flows are electronic. In listed derivatives, the market is polarised so clients are either exclusively electronic (usually for low latency), or intensively use voice. The fact that clients still want high touch execution shows how broking is still a people business. "Each time we increase our high touch offering, we improve client penetration, quality of coverage and the stickiness of the relationship," points out Banneville. "Everyone knows that electronic execution is more efficient, but some funds have a shortage of traders, and others appreciate the market colour and intelligence around flows, such as index re-balancing or calendar rolls that can come from a conversation with a trader," he explains.

Similarly, clients' preferences for venues will vary. In simple terms, "there are two types of clients. Some are afraid of the dark, for different reasons. Others want as much liquidity as possible for larger orders," Banneville finds. Societe Generale Prime Services has its own ECN (Electronic Crossing Network) and clients may also tap into most of the dark pools, but by 2018, ECNs may become Systematic Internalisers (SIs). How much dark liquidity moves onto other venues, such as SIs or MTFs, is one of the big imponderables. Banneville seems confident that at least some of it will remain (either below the double 4% of venue volumes/8% of market volumes cap or subject to the Large In Scale (LIS) waiver).

Smart algorithmic execution

Algorithmic order flow goes through a smart router. Societe Generale Prime Services handles listed derivatives and cash on one platform to carry out cross-asset trades, such as equitisation or basis trades, 'natively'. "The algo can take care of benchmark historical volume, dynamic volume, price constraints and volume constraints such as VWAP," explains Banneville. "Based on asset-class, tactical decisions after orders are sent include how to sweep and reload, which markets to access, how to rank venues in order of priority, how to control for slippage and so on." Algorithms are being tailored to individual clients' needs and are adaptive. "For Cash Equity, we change the smart order router priority based on QVM (quality venue measurement) over the past month," explains Banneville. Some clients delegate the choice of algorithm to the 'algorithm wheel', determining which algorithm to use based on the security or instrument, volatility regime, bid/offer spread, order size, average daily volumes etc. "Clients are becoming more quantitative and savvier as electronification progresses and MiFID II comes." And algorithms are ubiquitous: "the market is becoming geeky. You cannot escape electronic execution any more. Even if you trade manually, at some stage the order will go through an algorithm," reveals Banneville.

Co-location

Societe Generale Prime Services is seeing more and more demand for strong and robust colocation. It has its own colocation system (but is not in the super ultra-low latency space). Banneville observes that "the network of colocation services matters as much as colocation itself." Their benchmarks are radically different. "Colocation is measured in microseconds (millionths of a second) while networks of co-location are measured in milliseconds (thousandths of a second)," he says. Milliseconds are also the periodicity of time stamping for MiFID II purposes.

Measuring best execution

Measuring best execution and market impact could become more important and Banneville speculates that "MiFID II could change not only liquidity but also market behaviour. Many market makers that currently inhabit dark pools have become, and will become, systematic internalisers. We may see less mean reverting behaviour and more signal-based strategies." The downside of this, however, is that Banneville fears "the same average daily volumes may lead to larger market impact, based on what we see in the US."

Market impact can be the largest constituent of Transaction Cost Analysis (TCA), which was until recently often delegated to brokers. Now Societe Generale Prime Services' clients are recruiting quants from investment banks or universities to develop their own systems and standardise TCA over markets. Best execution is a multi-factor concept. Quants document how markets are accessed, their microstructure, deviation between initial and arrival price, the amplitude of the trade over the life of an order, and a whole range of other considerations. "Best selection rhymes with best execution and we have always marketed ourselves on the quality of our execution and algorithms," says Banneville. "We are a global tier one player for execution. Being more nimble than the bulge bracket lets us cover all asset classes and regions."

Clients are choosing brokers for their breadth of services and quality of execution. But in a fragmented market, there is space for multiple participants. The reality is that clients may rotate around a pool of brokers to optimise execution quality. **THFJ**