Centralized Trading

Benefits, Best Practices, and a Path to Implementation

Executive Summary

Abstract

What is centralized trading? Does it make sense for your institution? Are you ready to undertake this journey? What will it cost? What are the benefits?

This white paper explores the benefits and drawbacks of centralized trading. We offer decision criteria for asset management firms who are considering or on their way to centralized dealings, to assess their unique circumstances, costs, and other constraints before implementing a centralized framework. We develop best practices to implement centralized dealings, including good governance, regulatory requirements, defining order types and cross-asset best execution, working from home and technology prerequisites.

The analysis draws on the existing body of research for trading desk structures, industry trends and best practices, scenario analysis to estimate the benefits net of costs, and case studies from global asset management firms.

To read the full white paper, please follow this link: **https://www.bci.ca/media/insights/**

Executive Summary

The world of trading and the role a trader plays within a firm has transformed over the past decade. A shifting regulatory landscape following the 2008 financial crisis, rapid advancements in technology and increasingly complex global financial markets have all impacted trading. To meet rising demands, many organizations are implementing a centralized trading framework in which a single group of traders handle all trades, across all asset classes throughout the firm, from one hub. This paper explores the growing need for centralized dealings in the asset management industry, considers the key benefits and drawbacks of implementing a centralized execution desk, and recommends best practices for firms to use in implementation.

The findings are informed by BCI's journey in developing its own centralized trading function. The development of the function took place as BCI was rapidly internalizing assets and implementing more sophisticated strategies across asset classes – offering a blank slate from which to build. From the onset, it was clear that a centralized trading structure including strong governance controls and a unified cross-asset approach were necessary. Today, BCI's derivatives, trading and indexing team has a cross-asset mindset supported by a strong focus on continuous education to advance each member's theoretical and practical understanding of cross-asset derivatives and trading in global markets.

WHAT ARE THE BENEFITS OF CENTRALIZED TRADING?

A centralized desk allows a firm to leverage benefits from ***one voice and one wallet***. *One voice* represents a unified approach to negotiations, driven by a common understanding of how and where a firm does business with its partners across the organization. *One wallet* represents the line of sight and common principles for all transactions and commission costs and supports firms in using data to ensure *fair service for fair payment*.

Best practices in good governance are also supported by centralized trading. Firms can mitigate operational, reputational, and legal risks by staying at the forefront of developments in governance and focusing on key stakeholders. Further, centralized dealings present an opportunity to integrate environmental, social and governance factors at all stages of the investment process.

Perhaps one of the most powerful benefits is the potential to transform the role of the trader and support a performance-based team environment. Centralized trading moves the role of the trader from an operational focus to an advisory role – opening opportunity for traders to add significant value in the investment process. A centralized desk also functions as a meeting place to discuss cross-asset data, and to uncover high-impact insights and new investment and trading ideas.

KEY RESEARCH FINDINGS ON THE BENEFITS OF CENTRALIZED TRADING

- ✓ ***Enables the firm to speak with one voice in negotiating the best possible result for clients with respect to commissions, deal flow and service levels.***
- ✓ ***Enables trading from one cross-asset desk with management oversight, controls and compliance.***

- ✓ ***Mitigates legal, operational, and reputational risks - and offers a unique opportunity to influence Environmental Social and Governance (ESG) practices with broker partners.***
- ✓ ***Facilitates streamlined processes, efficiencies, and scalability for growth.***
- ✓ ***Allows the primary focus of the trading role to move from operational to advisory and opens opportunity for the trader to add significant value in the investment process.***
- ✓ ***Promotes a performance-focused team environment with collaboration among asset classes.***
- ✓ ***End-to-end control of physical and synthetic assets to optimize collateral, securities lending and financing, and counterparty risk management***

WHAT ARE FACTORS AND TRENDS IMPACTING TRADING?

Changes in regulation around the world have heightened the scrutiny of trading operations and resulted in the need for stronger governance practices to protect financial markets and investors. As markets and regulations evolve rapidly and asset managers adapt and grow, client needs, and expectations are rising in tandem. A review of legislation related to centralized trading in major developed markets, including the commonalities and differences across jurisdictions, surfaces a common thread of best practices. These include:

- the fiduciary obligation to put client interests first;
- the need for a firm-wide, cross-asset best execution approach;
- full segregation of duties and centralized controls in a single order management system (OMS); and
- centralized oversight of costs.

In addition to new regulation, changes in market structure are also largely driven by advances in technology and the availability of data, which has led to an increasingly automated electronic ecosystem. The development of electronic market structures in public markets, futures and options have changed the way people trade. Leading technology facilitates cross-asset best execution and related processes. Based on the research and analysis, there is value for firms in segmenting orders based on the needs of the trade, into “low-touch”, “mid-touch” and “high-touch” categories. By segmenting orders this way, firms can apply cross-asset best practices and insights to their executions, and in some cases, codify best execution rules through automation. Technology also enables the one wallet approach, as centralized management of trading and commission data increases the potential to better negotiate pricing, trade terms and fees for clients.

Additionally, the growing use of multi-asset strategies is often a precursor to centralized dealings, along with an increase of in-house asset management. Firms with a variety of order types, complex strategies, and advanced data needs, will benefit most from the new insights and opportunities that centralized dealings brings, in addition to fee savings.

Influenced by these trends, desk structures across the industry are evolving, and traders are required to do more with less, including executing higher volumes and more complex trades. While the sell side has taken the lead in the evolution with efforts to downsize and centralize dealings, the buy side is following suit. Analysis of case studies show clear benefits from implementing centralized dealings for virtually all global asset management firms and for firms that engage predominantly in passive cross-asset strategies or highly active cross-asset strategies.

Finally, the onset of Covid-19 and circuit breaker lockdowns demanded that firms move entire trading operations to employees' kitchen tables or home offices. Complicating the matter even further, the shift happened in a matter of weeks. Over a year on from this event and with work from home still in place in many organizations, it has been become apparent that the benefits of centralized trading do not require one physical location. However, asset management firms must tailor their approach to address the risks of working from home to ensure the effectiveness of surveillance is not diminished.

WHAT ARE THE BARRIERS TO IMPLEMENTATION?

While the case for adoption of centralized trading is evident there are barriers to implemenation that firms should be aware of.

Considering the costs of implementation, the potential benefits of centralized trading are different for each firm. Modeling suggests that most firms with a minimum of six to nine product types including high-touch orders like derivative, asset allocation or transition management trades, would benefit from implementing centralized dealings after accounting for the costs of implementing a leading OMS. However, small firms with only low-touch orders or a mix of low- and mid-touch orders may not see a net benefit. The benefits of managing a centralized trading desk internally need to outweigh the costs.

Within fixed income trading, there are specific impediments to implementation as the market has been a laggard in electronification due to unique market structure challenges. Trading firms have adapted and innovated amid regulatory pressures and are now technologically ready to reap the benefits of centralized trading which extend to fixed income. Despite the advancements, a cultural shift may be needed in order to implement this final frontier.

The evolving world of work from home and necessity for a tailored approach also increase the complexity of implementation. Firms must consider the impacts on governance structures, culture and risk mitigation.

SUMMARY

As asset managers strive to adapt to regulatory and technological changes in global financial markets and to always serve clients' best interests, it is an opportune time to review the benefits provided by centralized trading. A centralized trading framework helps reduce legal, reputational, and operational risks; and supports the efficient flow of trading, market and client portfolio information. Further, it promotes a performance-focused team environment and a culture of strong ethical and governance practices. While the evidence points to the many benefits of centralized trading, it also demonstrates that not all organizations will benefit equally from the implementation. Organizations will need to consider the unique cost-benefit outcomes based on their own size, structure, and technology foundation.

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