FIA EUROPE

INFONET

Start-ups, FinTech and disruptive technology

How derivatives product offerings are evolving

SEPTEMBER | 2015

INNOVATION

INNOVATION IN TECHNOLOGY, PRODUCT AND PROCESS

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WELCOME TO FIA EUROPE INFONET

It seems that you can't open the pages of a financial news publication or click onto the link of a conference programme these days without seeing the term 'blockchain' featured. While bitcoin has been a topic of discussion for some time, it is the technology that underpins the trading of this virtual currency that has grabbed the imagination and the headlines.

As one news service wrote of a survey of top FinTech executives this summer: "We've seen the future and it's blockchain." This contrasted to the previous year's survey of FinTech specialists, which found that big data was the main event in 2014. It also mirrored the findings of FIA Europe Innovation InfoNet this year, where blockchain also replaced big data as the most mentioned topic of the day.

One executive in this year's survey told the news publication "the more challenging question is whether [blockchain] will be a disruptive revolution or collaborative evolution?" His sense was that it would be the latter, with blockchain providers partnering with existing market participants to provide the efficiencies expected of the technology. This is already evidenced by the number of banks and market infrastructure groups, such as UBS, Nasdaq, CME and Eurex, all announcing explorations in this space.

Whether or not blockchain does ultimately revolutionise markets remains to be seen, but the thirst for innovation and the appetite for the efficiencies they can provide will continue. The launch of the Innovation Pavilion and Hall at FIA Expo in Chicago in November will provide the opportunity for a range of FinTech start-ups to showcase their offerings to an industry that is eager for services that can meet the challenges of an increasingly complex and costly environment, while offering solutions to the endless flow of regulatory obligations.

Of course, the real challenge is to spot what will replace blockchain as the topic of the moment next summer. Suggestions on a postcard, please…

Emma Davey

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A REPORT ON THE 24TH FIA EUROPE INFONET

KEYNOTE ADDRESS: INNOVATION IN TECHNOLOGY

Keynote speaker Udayan Goyal,
Co-Founder and Co-Managing Partner, Apis Partners

Through his keynote address and using real FinTech industry examples, Udayan Goyal set the scene of how, for the first time, it is not just regulation and risk management driving changes within the industry, but new technology and innovation. "It may fundamentally redefine the way this industry is run in the future and the business models that underlie it," Goyal explained.

The trigger point for the change has been a combination of the 2008 crisis and the evolution of the economy – the industrial economy in which we have all grown up has effectively become an information economy, where we are highly networked and we talk to each other in real time using technology that sits in our pockets, rather than in trading rooms.

"The way we do business has evolved and those network effects have changed the way business is run," he said. "We are moving away from high transaction cost environments to low transaction cost environments. We are moving away from using very large infrastructure that sits in data centres, to the cloud."

With these trends fast becoming permanent features of financial services, the high barriers to entry, which have typically characterised the industry, are beginning to fall away. This, Goyal highlighted as one of the big instigators that has spurred innovation and created what we now know as the FinTech industry. Lower costs meant that 'tech guys', like the ones from Goyal's following example, who have never seen financial services but are looking for a problem to solve, are able to enter the market.

TECHNOLOGY AS AN ENABLER

The founders of Climate Corporation began by noticing that the US had stochastic weather data available on the cloud (because the government publishes it) for the last 120 years within a mile of any major area in the US. Using a cloud computing programme, they built a simulation model to price up weather derivatives in a certain period of time.

You could input parameters for rain risk, for example, press a button and about 48 seconds later a price shows up. Goyal commented that "this type of calculation, would have usually been an overnight simulation, so 48 seconds was nothing short of miraculous!" They went on to find an insurance company who actually underwrote the risk, and started to sell online insurance in the US to the farmers. This demonstrates how quickly this industry can change and how technology has become an enabler – but there some issues that means it has been slow to filter into the wider industry.

These include high barriers to entry, very entrenched incumbent firms and a high degree of regulation.

Figure 1: Centralised ledger

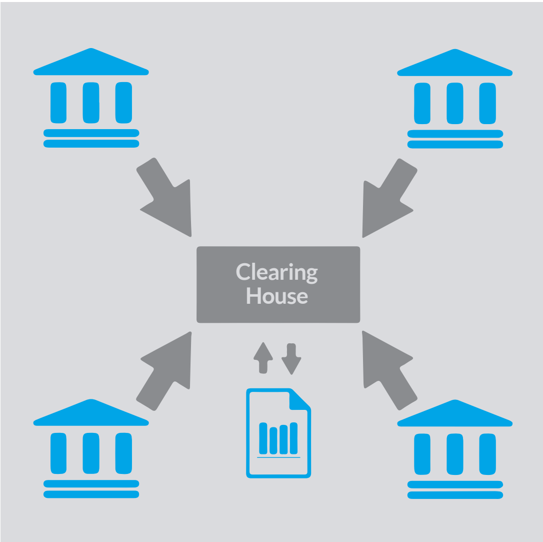
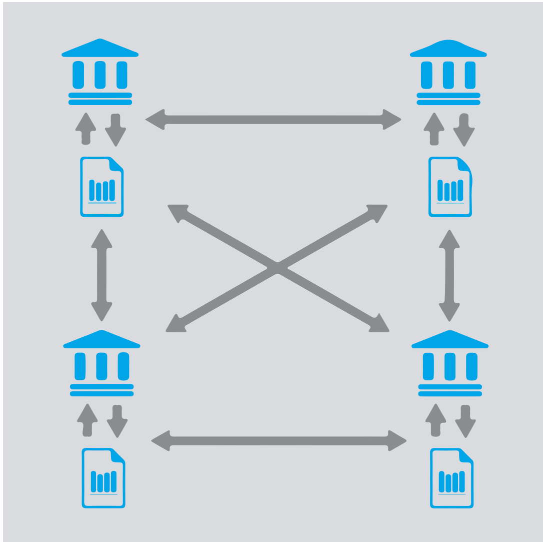


Figure 2: Distributed ledger



However, an increasing number of FinTech ventures are starting to embrace these issues and find solutions for them. So we are now moving away from FinTech 1.0 – where new players were typically looking at advances in digital technology and delivered products that were user-friendly and less costly to deliver - to FinTech 2.0.

"We are moving into a market of open data and open APIs where companies can access data that wasn't available to them before. We are moving on from disrupting the front-end processes to the middle and back-office processes and are starting to make fundamental changes to the actual infrastructure and the processes at the core of financial services. FinTech 2.0 represents a broader opportunity to re-engineer the fabric of global financial services," he added.

Goyal identified blockchain technology as a real game changer for the InfoNet audience. Today, in almost every process that we work in, everything runs off a centralised ledger, meaning there is a single ledger that acts as the master ledger that says an asset is owned by A or by B, and once it is in that ledger it is irrefutable and that becomes proof of ownership. A blockchain or 'distributed ledger' is essentially the same, except the ledger exists in everybody's hands so there is no single point of failure within the system.

He went on to explain that this changes the economic model of transfer of asset ownership, it changes the time it takes to clear a transaction; and it changes the importance of certain players within the value chain.

Goyal then pointed out the advantages of the distributed ledger:

- Closed as well as open – unlike bitcoin, closed ledgers require participants in the network to already be identified.
- Irrevocable and lower cost transactions – clearing and settlement near instantaneous, more accurate trade data and reduced settlement risk.
- Guaranteed correct execution – tamper resistant due to peer-to-peer architecture; less need for supervision and associated costs.
- Transparency – accessible historical records of all transactions created for effective auditing by participants, supervisors and regulators.
- Wide application – almost any intangible document/ asset can be expressed in code to be used in a distributed ledger. Applicable to any financial instrument, whether it be bonds, equities or derivatives.

The next evolution, Goyal claimed, is smart contracts, and they are computer programmes that can automatically execute the terms of a contract. "They are a mixture of a distributed ledger with the programming that allows you to actually update that distributed ledger and the ability to do the transaction," he added.

It relies on its public key infrastructure, which is public/private cryptography, so as long as you have your private key within the system, you can authenticate yourself and each transaction is then measured on the ledger and it's almost 100% tamper proof at that point.

The beauty of a distributed ledger, he pointed out, is that you can try and tamper at one point of the network, but it's the replication across the network that authenticates the transaction. "It's impossible unless you have literally infinite computing capacity to actually beat the replication time across that network," he said.

A further benefit is delivery versus payment (DVP). "So I transfer the asset, you pay me the money – you can do that DVP instantly, taking the settlement time close to instantaneous," explained Goyal. Also, there are many open source smart contracts so "rather than being the Microsoft-style proprietary walled-in garden, we're moving toward an industry that relies on open source code. People are developing code which anybody can use," he continued.

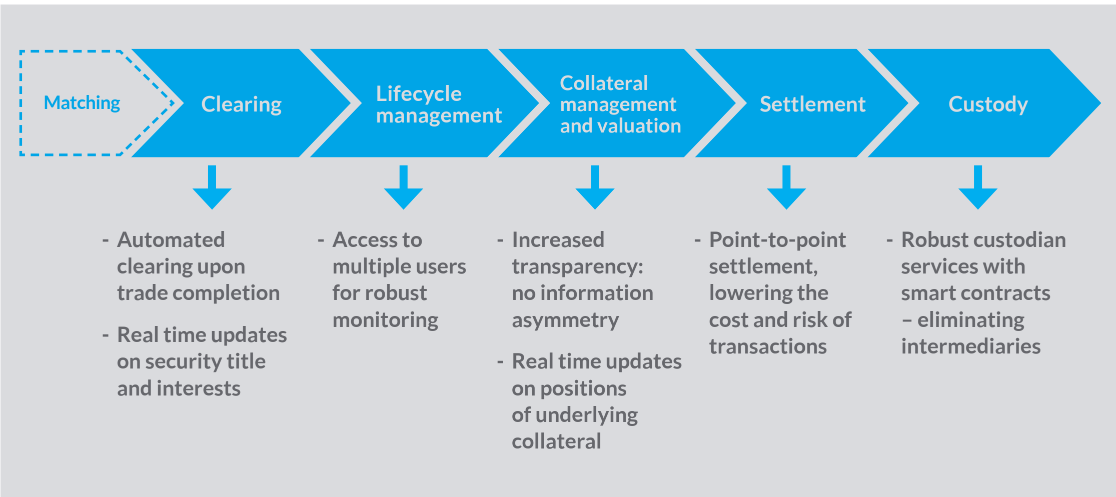
Goyal cited Eris Industries, Ethereum and Codius as examples of companies that are building software that allows anyone to build their own low-cost, secure data infrastructure using the smart contract technology.

"We're moving toward an industry that relies on open source code. People are developing code which anybody can use."

Using post-trade to illustrate his point, he then moved on to talk about the application of this technology to securities settlements.

"You can have automated clearing immediately upon the trade completion," Goyal said, "real-time updates for everybody around the title of the security and the interest. You can open up access to anybody so they can

Figure 3: Post-trade lifecycle



" You never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete."

monitor where you are in the lifecycle management. In terms of collateral, you remove all the information asymmetry from the system and you can look at the real time positions for that collateral. You can then do a point-to-point settlement so you get rid of the concept of having a single point which is holding the ledger, and that reduces both the cost and risk of the transaction. And finally, you have a custodian that can deal directly with the end customer using smart contracts rather than through multiple intermediaries."

A further example of application is to corporate actions, because the problem is you need an arbiter between the three different people who say the amount is A, B and C – you don't really know which the amount is, and this solves that issue almost immediately.

ENORMOUS POTENTIAL

The applicability of this technology is huge, and, in terms of what it means for the futures industry, Goyal suggested two possible outcomes. The first is total disruption, meaning that all market participants have direct access to a decentralised securities depository and therefore will be able to do direct settlement without anybody in between. This would have an interesting effect on the industry because if you move to an immediate settlement, the need for collateral management and other things that you do to create the security that underlies the transaction starts to quickly disappear.

The second outcome, which Goyal argued to be more likely – fortunately for the people in the audience – is the integration of the technology around distributed ledgers into the post-trade ecosystem. This would mean that custodians or settlement infrastructure providers (CCPs) will start to use this technology to record ownership trades between them. Investors will still be required to use a custodian to have access to the market, and the ledger will only be accessible to authorised market participants.

Although Goyal considers the second outcome most likely for our markets, he does believe that, "the developing markets may leapfrog the developed markets and move directly to the first outcome."

Taking Nigeria as an example, he explained that the country would like to create a derivatives market and rather than using the traditional CCP infrastructure (because it simply does not have one) it is looking to blockchain technology or smart contracts as a way of developing its markets.

A lot of innovation is coming from the developing market because the lower barriers to entry and lack of legacy technology makes it possible.

Both outcomes are starting to emerge in our market, illustrating the need for change, particularly in terms of post-trade, which relies on expensive proprietary technology and manual processes. The change is being forced by heavy regulation, the need for cost reduction as trading margins are being squeezed, and innovation and the desire for shorter settlement cycles.

Goyal also briefly mentioned that innovations around workflow management are proving to be important to the industry in order to reduce costs and pick out inefficiencies, providing the following panel with a prominent discussion point.

Goyal concluded his keynote by quoting architect and futurist Buckminster Fellow – "you never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete." ■

SESSION 1: INNOVATION IN TECHNOLOGY

MODERATOR

Emma Davey, Director: Membership and Corporate Affairs, FIA Europe

PANELLISTS

Chris Bates, Founder, Abide Financial

Julie Carruthers, Head of Operations, Global Broking, ICAP

Sebastien Carême, Head of Post-trade Product Strategy, BGC Partners

Andrew Davies, Founder & CEO, Cloud Margin

Udayan Goyal, Co-Founder and Co-Managing Partner, Apis Partners

Simon Heather, Group Chief Technology Officer within Capital Markets, SunGard

Michael Marconi, CTO, Duco

To what extent can FinTech, and disruptive technology specifically, improve process within the derivative markets? This first panel looked at the relationship between new technology and the incumbent firms, gathering views from both start-up and long-established software service providers, as well as brokerages who use their services.

Quoting Andy Ross, Managing Director at Morgan Stanley, from a previous event, moderator Emma Davey pointed out that "there are significant challenges to innovation when the downside to getting it wrong has the potential to impact your firm as a whole."

The start-ups on the panel were clearly aware of the need to focus on finding the solutions for their clients. Chris Bates from Abide Financial recalled that his firm "spotted a big problem in 2010," which was that the market was generally being underserviced. "Where there is a gap in the market there is the opportunity for innovation," he said. With the regulators becoming more demanding of organisations, the risk of getting things wrong was getting higher and this was also having an impact on costs.

As a big data company, Abide developed the technology to find issues and trends in massive amounts of data, enabling firms to submit accurate reports. Bates believes that the market should be concentrating more heavily on generating profit and value for clients, not serving the regulators. Abide is able to focus on real client problems, which can be solved by using disruptive technology – as a start-up Abide is small enough and agile enough to be "open and able to fit into the market easily".

Cloud Margin's Andrew Davies takes a similar approach. The start-up talks to firms and sees where their problems lie. Cloud Margin found the big issue was work-flow. Using technology that almost eradicates room for human error, it helped to streamline work-flows and make them more efficient, again illustrating that innovation stems from the market's needs.

Michael Marconi from Duco has had a similar experience. Duco discovered that firms found challenges and inefficiencies in data reconciliation across their operations, and therefore saw an opportunity to innovate in that space. Using experience the company already had in applying natural language rules to technology and dealing with data transformation and validation, Duco solved the problem by bringing all of its intellectual property to one platform "allowing operations and finance staff to very quickly and independently set up data controls that they can continue to evolve over time as necessary," he explained.

In terms of relationships, Duco's clients include a tier one investment bank, which Marconi pointed out reflects the fact that, "over time the industry will move away from expensive in-house builds and very expensive deployment of legacy platforms towards much more reactive hosted services, best agreed services that can react to the really rapid pace of change of regulatory requirements in this industry."

The three start-ups on the panel explained that their development of disruptive technology is more reactive than proactive. As Bates described: "It's a barrier to entry issue, technology on its own doesn't really do a lot. You need to have appropriate knowledge of the financial market." So when it came to regulatory reporting, Abide had a knowledge of disruptive technologies and an exemplary knowledge of what to do with them in terms of transaction reporting. So although the approach to problem solving is reactive, firms can be proactive in terms of knowledge and applying the disruptive technology.

It goes back to the point about taking an agile approach to development, realising the gaps in the market and making use of the tools available, such as AWS (a cloud computing platform), which facilitate a relatively small development team to do some big things – enabling firms like them to get into the market.

"We use basic capabilities that were out there and applied them to a very precise and niche aspect of this market and delivered something to the client," Bates added. Udayan Goyal from Apis Partners agreed, stating that "it goes back to what is the problem you are trying to solve and how do you actually apply technology to that market."

According to Goyal, the big shift in innovation in the industry happened after the financial crisis, which "took away the credibility of the incumbent institutions" making room for small start-up firms to move in with their disruptive technology. Furthermore, the new regulatory-heavy environment produced obstacles that needed to be overcome and could be done so with this new technology.

So, once you have a product or idea, how do you go about selling and implementing it? One of the biggest problems that was raised at last year's InfoNet on innovation by Mark Beeston, Founder and CEO of Illuminate Financial Management, was getting a large institution to speak to start-ups, listen to what they have to offer and convince them that they will still be here in three years' time!

The key to Duco getting their foot in the door, said Marconi, has been having a large institutional investor behind the firm [ICAP] and that has always helped Duco get past any financial due diligence that's cropped up.

Davies commented that there is more of a reticence towards start-up firms in the UK than there is in the States. "Over here it really helps to have some sort of real names behind you to give that credibility." So Cloud Margin took some 'angels' on board who have very good names within the industry, who really believe in what the firm does. As Cloud Margin started dealing with bigger institutions it has been increasingly important to get institutional backing and it was actually Beeston through his venture capital fund that invested in the firm.

Turning to the IDB's take on these relationships, the panel highlighted the challenge that it is not always easy to see the investment that is needed in some of processes within the client firms themselves. For example: "If you are doing reconciliations by spreadsheets and you are doing them fine then it appears there is no problem so if it ain't broke."

Seb Carême from BGC Partners added that the IDB has a strategic investment arm where it is starting to see small vendors coming in looking for sponsorship. BGC is finding that there are often innovators who have got a fantastic product, but need some help bringing it to market. BGC's strategic arm is helping partner with those vendors. The

"Technology on its own doesn't really do a lot. You need to have appropriate knowledge of the financial market."

Chris Bates, Abide Financial

challenge to this relationship is ownership. Although BGC is helping start-up firms, it needs to ensure that it doesn't act as a "contagion" to their brands, said Carême, because BGC is an execution venue, other execution venues might not want to take on that product.

For BGC, "it is about looking at the whole of operations from top to bottom, looking at the components that everyone is using and coming up with products that are actually reducing risk," he explained.

So, how does this innovation compare with incumbent utility solutions, which standardise processes in order to provide greater efficiency for the industry? Simon Heather from Sungard said that its approach is to involve its customer's operations staff in improving the software by giving their feedback and driving efficiencies into the next-generation platform – a sort of mutualisation of the development process. By keeping it all in-house and taking ownership of upgrading the software and having the operations staff feeding directly into development, there is huge improvement and costs remain down.

Goyal quickly dismissed the idea of a closed environment, in favour of open source. "The whole concept of incremental improvement of a certain process in the industry starts to become a collaborative open source process that everyone can contribute to," he claimed.

"With the right people in the different parts of the value chain becoming the process implementers of those improvements coming into the system." The danger in a utility model, he continued, in a closed source environment, is that over time you are developing a single point of failure, whereas, with open source environment, people share each other's risk models.

Bates suggested that 'vanilla' utility models should be viewed from the client's perspective. "They have multiple systems, venues and problems which need looking at on an individual basis." Abide's approach is to use the utility models on certain segments of the market. "communications can be shared, the infrastructure can be shared, but the actual problem-solving element of the service cannot," he argued.

According to Marconi, Duco has yet another approach whereby it has bilateral relationships with clients who are on the buy side as well as the sell side. "It would only be a short leap for them in the future to start connecting workflows to one another and thereby creating a de facto utility."

"It is about looking... at the components that everyone is using and coming up with products that are actually reducing risk."

Sebastien Carême, BGC Partners

As users of services from both incumbent firms and start-ups, FIA Europe's Davey asked how BGC integrates the two and whether any problems have arisen. Carême responded that they are always looking at existing relationships that they have with vendors to see whether or not there's a good fit, but ultimately the firm is driven by what its customers want.

"The challenges are integrating new components into existing utility-based software and whether or not those utility functions are protectionist of any other components, and whether or not that affects any kind of SLA around that," he explained.

Sell-side firms will always have relationships with the big incumbents in certain sectors, but also with the smaller, agile FinTech firms that work with you on a more personal level as well as fixing some real issues.

"They allow you to see commercial opportunity in what operations do," said one speaker. The big incumbents should stay in that space and innovate there and then you have the smaller agile companies that deal with the more niche problems. The two types of firms complement each other.

"[Banks] want to keep their influence, whether it's a sound business decision or not."

Andrew Davies, Cloud Margin

From Sungard's point of view, Heather responded that historically it would have simply bought the smaller firms. Sungard is "now an organic growth company, which means innovating with new technology and building products to serve new markets, such as collateral."

Generally, the start-ups are finding an area in the market that is not served or they offer something slightly different, perhaps at a different cost point, he continued. For example, they may target a start-up broker dealer who doesn't want to pay for a large system. So although Sungard isn't directly involved with them, they will compete with them where it makes financial sense.

Goyal countered that, "culturally there is a gulf between some of the more established IT vendors and some of the start-ups and they are not a smaller replacement for existing legacy onsite deployment software. They are disruptive because they don't play by the old set of rules."

Bates added that it is not just about the traditional vendors and the new vendors but also the big institutions, who should be raising the bar in terms of what they expect. Abide is having to educate its clients about what they can get; "if they demand more, it will generate innovation within the market because the prize is quick growth, value in your company and return on your investment."

A further issue that both Bates and Marconi pointed out was the problem of procurement among big institutions, where 'processes are a legacy of buying practices from 15 years ago, and they are not keeping pace with the way that technology is changing.' It was thought that these long processes had a lot to do with having to measure and manage risk.

Goyal shared that some of the most successful start-ups he has worked for have managed to "convince a large institution to do incremental deployment that's not a replacement of legacy technology, but rather using the new process alongside the existing process so you can measure the ROI on both, start to finesse how you work with both processes and in many cases you can integrate the two." This way you will get process improvements and you will have the scale of the large provider, which gives you the security you need.

Heather felt that often banks want diversity in terms of who is supplying systems "which can work quite favourably for start-ups." Equally, they may want to reduce vendors and so remove your system simply because they want fewer vendors.

Davies thought that banks could also be resistant to technology because they can see it as a threat to their jobs. "They want to keep their influence within the company, whether it's a sound business decision or not," he suggested. However, Heather was quick to refute this comment, explaining that over the last two years he has seen managed service software become increasingly popular with banks.

The session closed with a member of the audience asking about the technologists who are developing new software. Bates commented that there is a lot of competition to attract people to your company so Abide tries to "innovate internally".

Goyal agreed. "The millennial generation's motivations are so different from what we have grown up with. They are not motivated by money, they are motivated by what they are doing day-to-day and by the environment that they live in." He finished by saying that the future is in the "knowledge economy" and that code is a language, like English, you need to know – that is why he will be sending his five-year-old daughter to code club next year. ■

INTERVIEW: BRENDAN BRADLEY, EUREX

EMMA DAVEY INTERVIEWS EUREX'S CHIEF INNOVATION OFFICER

ED So, Brendan, you are Chief Innovation Officer at Eurex. What does a chief innovation officer do?

BB If you believe my boss, what I hear him constantly telling people in meetings, it is that he pays me to sit on a beach and think.

ED Can I have that job?

BB But you can see from my pallor that I don't spend much time doing that. The thing is that as the world has changed, we found that we had a product development department, and the clearing group, and sales people... And then there were areas that just seemed to fall between each of those stools. So, you need somebody to pick up the ideas that, perhaps, spanned a bit of each and champion some of those ideas and push them forward.

In a nutshell, what I spend most of my time doing is looking for opportunities that emerge between the gaps of what's going on in our changing marketplace at this point in time.

ED Deutsche Börse is active in pushing this activity in its Open Innovation programme. Tell us about that.

BB We started the Open Innovation idea last year and it was really an extension of an internal programme called YouNovate, where employees can put forward their ideas, they're evaluated and employees are possibly given some monetary recompense if the ideas are picked up and run with.

So we figured that while it's nice to have some ideas coming internally, we should also be looking externally. So the original viewpoint was that with all the industry change going on, we could leverage the membership and attempt to get more ideas coming directly from them and be more engaged with the community there.

What we found was that it hasn't helped us at all with that. We've found instead that it's more the FinTech community that are engaged with this. So we talked to them a lot more through that channel. The piece that we would like to tick the box on for next year is our engagement with the whole FinTech community.

However, I think the piece that we missed was really engaging more with the member community. And the FinTech challenge that we're going to be involved in now at Level 39 at Canary Wharf – which we are dubbing as 'reg tech', as opposed to FinTech – should help us to do that. We're working with Dassault Systèmes, who have been running the challenge for the last couple of years.

We've invited banks come in to breakfast briefings that we've held over the last few weeks, with the goal of asking them where their pain points are, and then running the challenge on the basis of some of those areas they feel are the main pain points. Therefore, we can hopefully marry the bank community ideas on one side with the FinTech solutions on the other and get them working together on some of the topics that everybody feels should be addressed today.

ED We heard from the panel talking about FinTech and developments in technology and how they can enhance and help the process side of the business, which is obviously some of what you're talking about. How does that relate to product development within the exchange? Do you feed off ideas that emerge from the technology space, or does technology enable you to develop some of the new products that you're looking at?

BB I think just by being in the space, you get various different ways of approaching it. If we go back to the first investment that we took in a start-up, that was Digital Vega on the FX options side. That was really looking at taking a bet four years ago on more RFQ-type technologies coming into play and how the market might use them.

So it was more a market structure play and, yes, they continue to be alive and well in that business today. So you could argue that that's a development of existing and new product, particularly on the FX options side, that we didn't have at the time.

Then if we're looking at some of the other areas that we've gone into, not necessarily investing but collaborating, it's more around predictive analytics. Can we find some firms that have interesting algorithms that we might want to use? If we give them some of our data, we can maybe see how they would run that big data within their algorithms. And one would hope that this would throw out some snippets of information that we possibly wouldn't have before. So that could help us with, perhaps, sales or marketing or developing new or existing product.

And then the third angle is on the GMEX side. GMEX [which launched constant maturity swap futures in August] came to us as an exchange from a clearing point of view, initially.

When we understood the product they had, we recognised that they had two elements to their business. One was that they have a swap product idea that we hadn't necessarily thought of ourselves, and so therefore we should support them more broadly.

Then on the flip side, they're also a technology provider themselves, and we have the opportunity to work with them in emerging markets where you wouldn't provide a Eurex "tanker" as the technology platform, but you could potentially work with them to give them a GMEX type of technology. They would be much more agile and nimble as they are in their existing business, and we could provide the credibility and maybe some of the clearing facilities needed.

ED So, why not do some of those things yourself? Is it simply a case of being less nimble?

BB It's not always the fact that exchanges have all the best ideas. And if you think about it, historically, some would say we've never had any good ideas. Most of them

> "If there's an opportunity to buy into something that's there rather than developing it yourself, it's something you've got to consider."

have been pinched from somewhere else! If you talk to all the IDBs, they'll tell you all that happens is that they build the product in the OTC space and once it gets to a level where it's effectively standardised, the exchanges come along and nick it and then their margins go down.

So, yes, that perhaps has been true over the years, but I think in today's world, everybody's looking for ways in which they can generate more revenue. So therefore if there's an opportunity to buy into something that's there rather than waiting to develop it yourself, it's something you've got to consider.

ED And finally, what are your versions of disruptive technology that will 'upset the apple cart'?

BB Blockchain has been mentioned quite a lot today.

We've built our own prototype on the blockchain side and we are learning a lot about that. We wouldn't claim to be experts by any stretch of the imagination but we are actively considering alternatives.

I still feel that whenever we talk big data, it's always a question of how big it is and how you define it. But if you can run some algorithms and consider that all of the exchanges and the member community have so much data, which I don't think we fully utilise, that should present opportunities.

One of the areas it can help with is in topics like liquidity schemes, sales and marketing activities and so on. If you're going to slice and dice the information much more granularly, really understand where people are interacting from a flow point of view, these are some of the things that I can imagine being really interesting going further forward. And technology will allow us a lot more capability to analyse that.

> "We've built our own prototype on the blockchain side… we wouldn't claim to be experts… but we are actively considering alternatives."

WHAT WILL UPSET THE APPLE CART NEXT?

Fidessa's Director of Group Strategy, Steve Grob, picked the three new technologies and trends that he believes will have the biggest impact on the derivatives industry over the next few years:

1. BLOCKCHAIN - THE DISTRIBUTED LEDGER TECHNOLOGY

Advantages are that it solves the trust problem between two parties who wish to transact with each other, by distributing the transaction record across multiple servers that are open to all. By decentralising the ledger, blockchain has the potential to remove the need for third parties, such as clearing houses, currently involved in the chain. It has also, so far, proven to be tamper-resistant due to its peer-to-peer architecture.

However, it won't come without difficulties – there is likely to be a problem with regulation and different jurisdictions using it as a way to expand their territorial horizons. A second problem is that if we are to have different flavours of blockchain that require third parties to interpret them, it will only be a partial disruption and may not actually be worth it.

2. THE VISUALISATION AND CURATION OF INFORMATION

The problem in our industry, Grob claimed, is not finding data, it's that there is too much of it. How do you find the specific piece of information that is of real interest to you? There are technology platforms that organise the data you are interested in and present it as a digital footprint on your screen, enabling a more precise and efficient interpretation.

Unfortunately, in the finance industry, the ontology isn't quite there yet, but before long there will be the ability to pre-curate information and extract only the relevant stuff.

3. MICRO-INVESTING

Grob's final point was about the miniaturisation of our industry. With asset management, for example, there is an abundance of platforms for private and public trading or secondary trading of privately held companies.

These platforms enable us to manage our investments fairly easily by ourselves, therefore reducing the number of asset managers or even making them obsolete. Grob concluded that this type of innovation lends itself to a very different type of wealth management industry.

SESSION 2: INNOVATION IN PRODUCT AND PROCESS

MODERATOR

Emma Davey, Director: Membership and Corporate Affairs, FIA Europe

PANELLISTS

Brendan Bradley, Member of Eurex Executive Board and Chief Innovation Officer, Eurex

Peter Blogg, Senior Director, Agricultural Products, CME

Stuart Deel-Smith, Head of Product Development, Nasdaq NLX

Anthony Payne, Head of Business Development, Marex Spectron Pro Trader

Against the background of the global regulatory change agenda, the development of new products has largely taken a backseat in recent years. Now that the new regulatory frameworks are being implemented, however, there are signs that the industry will be renewing its focus on new product development.

At the July InfoNet meeting we asked how efficient the product development process is and where its impetus comes from. Is it end users, banks, intermediaries, exchanges or even the regulators who control and drive product development? Does technology play a part in the process? Or is it some or all of the above?

As one commentator had observed at an earlier InfoNet meeting, the banks had been beaten "almost senseless" by the need to comply with regulatory change, so would they be able to compete in product development with the exchanges or did the latter now hold the upper hand?

The banks clearly have a role to play, according to Brendan Bradley, Chief Innovation Officer at Eurex. "While they might be hurting, they are still the clearers," he said. "You can develop all the new products you like but if you have nobody to clear them, you have a problem."

"As we enter the new OTC world there are a lot of OTC products that are driven by banks," he continued. "Much of that comes from corporate flow, which won't necessarily go into interest rate swaps in a clearing environment. It will be interesting to see how that develops. Some might say that banks are being disintermediated by the exchanges and clearinghouses but if they're honest they will tell you that we're doing them a favour because they don't want to hold assets which will go onto their balance sheet and cause them capital adequacy concerns. They are actually pushing us to do that kind of thing as well."

Peter Blogg, Senior Director, Agricultural Products at CME Group, felt that banks had been central to his activities in developing new agricultural commodity contracts. "They play almost as important a part as the end-users," he said. "Financing is a crucial part of agricultural products and OTC business is an important part of that. The banks lay off their risks at the exchanges by having exchange-backed certificates for physical products and by being able to lay off their OTC business with us as well."

"It's the banks, end users, producers and consumers of the commodities who really drive product development," he said. "The exchange manages the process but if it finds itself actually driving product development, then it has to ask if it is doing the right thing. Without demand from the financing banks, the OTC desks and the end users, how does it know if it is developing something that the market wants? It needs the buy-in from the end user."

Stuart Deel-Smith, Head of Product Development at Nasdaq NLX, believes that the entire ecosystem drives product development. "End-users by themselves can't drive product," he said. "Nor can exchanges or technology. In my experience, product development departments at every exchange feel the need to develop new and funky products. They do the right thing by consulting with the market and they might even get some positive response which they take as a go signal. Exchanges continue to throw a lot of mud at the wall in the hope that some sticks. But a lot of products are not driven by the end user and to be successful you need tangible end user demand."

Blogg commented that exchanges often launched products that customers seemed to want but when it came to trading that product, they were often absent after showing initial interest.

He did not agree that the entire ecosystem needs to be there right at the outset. "You can't build a contract unless you've got the commercial paper from the end user coming in because without that you're building on sand," he said. "There are many examples of lookalike contracts being listed on the basis that the market wants them, but without fundamental support they are doomed to failure. You need to be offering a solution to a real problem and to build from the ground up. You do need some market makers to oil the wheels of the market, to help bring the physical market in. But the hedge funds, asset managers and prop traders etc will only come in when you have established a baseline of liquidity."

The panellists were asked if product innovation was easier or harder to achieve in the current environment.

According to Bradley, there was certainly less "low-hanging fruit" but "futurisation" offered areas to investigate. "Dividend contracts are a good example," he said. "The Lehman Brothers situation led, for the first time in my experience, to many buy side customers asking us if they could move their portfolio out of OTC dividend structures into an exchange-traded product. That obviously moved a lot of open interest over quickly. It will be interesting to see whether new product sets will evolve now. We've developed a whole portfolio suite around dividends. Interest rate swaps is the area that everyone is banking on and hoping to develop a whole new set of products around."

Deel-Smith believes that there are cycles of innovation in product development. "Looking back at the 1970s after the breakdown of Bretton Woods you suddenly had heightened inflation and exchange rate volatility," he observed. "That sparked the launch of financial derivatives. In the 1980s, option strategies and portfolio insurance found favour. In the 1990s it was exotic options,

"A lot of products are not driven by the end user and to be successful you need tangible end user demand."

Stuart Deel-Smith, Nasdaq NLX

because suddenly there was computing processing power. Through the noughties we saw a move towards exotic assets rather than exotic products. Suddenly people were trading volatility and credit as an asset class. The catalyst now seems to be regulation. Another driver will come along in the next decade."

Blogg felt that true innovation in product development in commodities had never been easy. "It's rare to have an overnight win but if you take the long view, there's still plenty of opportunity out there," he said. "For example, you might look at introducing a new delivery process in an existing product because a competing incumbent exchange's product no longer reflected the underlying physical market. However, you have to appreciate that that kind of innovation is a free option for a many customers. They are pleased you introduce the alternative, but whether they actually use it is another matter."

Anthony Payne, Head of Business Development at Marex Spectron Pro Trader, pointed to the cost of onboarding new products as having become a major issue for clearing firms in recent years, especially when added to the ever mounting costs of implementing new regulation. "Whenever a new product comes out, there is a cost to deliver that product to the client," he explained. "And, as we know, many of these products are doomed to fail. It becomes expensive for the GCM, who has to make a decision as to which products to back. For example, an exchange might approach one of our market makers with an incentive to encourage them to make a bid offer spread. The market maker, of course, wants us to connect for them. But there's no incentive for us, apart from potential round turns that we're going to clear, if it's successful. It's not the market maker who undertakes the cost of connecting, it's us. There are so many of these products coming out that it's difficult to juggle and to prioritise."

The buy side seem to have been more proactive in looking at risk management products in recent years. The panel were asked how prominent they had become in shaping new products.

Bradley explained that more of the buy side were approaching Eurex directly regarding potential models to enable them to face the CCP directly without having to contribute to the guarantee fund. "They don't like the mutualisation of that part of the business. And in terms of moving collateral, they are asking why they have to move it from here to there to back into the clearing house. They would prefer it if they could move it directly into the clearing house."

"For traditional asset managers, you could argue that the game is really asset allocation," he continued. "You could ask them how they are going to allocate those assets. And you could be flippant and tell them to forget about real assets but to put everything into derivatives. It will be interesting to see which buy side firms step up with respect to helping shape products. Entities in the US like PIMCO are as sophisticated, if not more so, than most of the other players on the street. But, in Europe, we don't have as many of that type. Maybe that will change."

Deel-Smith said he had had enquiries from a number of buy side firms expressing interest in derivatives and direct access to the markets. "Some are not just interested in using them but also in potentially providing liquidity," he explained. "They're also interested in efficient use of the collateral they hold for collateral transformation and funding margin. Instead of just holding cash assets long in a portfolio, they might use the assets in the repo and collateral markets and substitute the exposure via

> "There are so many of these products coming out that it's difficult to juggle and to prioritise."
>
> **Anthony Payne, Marex Spectron Pro Trader**

derivatives. A fair amount of talent and resources has moved towards the buy side. It seems they are waking up from their slumber."

Clearly, to successfully launch a new product, the right level of participation is needed in the first place. Everybody is looking for liquidity, but where does that liquidity come from?

According to Deel-Smith you must start with commercial demand. "Very often an exchange will try to create a shop window for commercial users by getting market makers on board in order to be able to show a bid and offer on a screen. But which came first? Was it the chicken or the egg? Was it the commercial user or the shop window? I've seen this approach fail on many occasions. Liquidity initially comes from commercial users. Market makers are there to oil the wheels and get the contract moving. That will in turn attract the buy side clients, the hedge funds, the CTAs and then the other prop speculators."

The panellists went on to consider the use of incentives for new product launches.

"We have all had our fingers burned many times with new launches," said Blogg. "We spent about a year developing the specification of the new cocoa contract we launched in March. We were trying to ensure we could solve the problems of the incumbent contract and that it would provide a much better pricing base for commercial users. We reached the point of asking if those people would actually be there on day one, because we've had numerous examples of every co-op, every trade house, or every processor in a certain market saying they would support a launch, but on day one most of them weren't there.

"This time we went back to the market and asked them to show their support for the new contract by paying us and in return we offered them a revenue share. So if the contract takes off they will participate in its success. We told them we would not launch it unless a certain number committed to this. When you launch and start paying market makers you can haemorrhage money. If you just offer a shop window, there's no incentive for these guys to come in."

He continued: "It's early days yet but we are seeing trades from those guys that have paid up. They have a vested interest in making the market work. We're building volume and open interest and it will be interesting to watch over the next year."

Payne referred to the business model which Liffe US had developed in building a clearing house which offset cash products against derivative products and was backed by a number of investment banks and high-profile liquidity providers.

"Offering stipends and market maker rebates is an expensive way of developing new product."

Brendan Bradley, Eurex

"With major investment banks on your side you would think that they really want your project to succeed," he commented. "You think that they will be in the game from the outset but then you see that there is no flow coming from the actual end users in the banks.

"This is because the investment officers in the banks don't want to miss out on anything. They throw mud at the wall, hoping that one of the projects they've invested in will work. But that investment officer has no influence on the trader. He might be asked to transfer 10% of his business from the CME Eurodollar contract to another exchange but all he is interested in is getting his orders filled on a liquid market. So, even though you've had the commitment from the bank, it's very difficult to get the flow from the trader."

Bradley observed that many incentive schemes seemed to hark back to the days of mutualised exchanges. "Offering stipends and market maker rebates is an expensive way of developing new products and it creates an expectation that it will happen the next time round as well," he said.

"The approach does work at times but you really need the paper coming in. It also depends on what type of products you're trying to build. If it is a portfolio of products from a range of single stock futures or dividend products, for example, some will work and some won't.

"Even if you come up with a new product which seems to address a customer need, the world, unfortunately, isn't always logical," he continued. "You would think that the customer would go for the better product but unless you get to a tipping point where liquidity actually shifts, he will often stay with the old one and run the basis risk or whatever the issue is."

Blogg felt there were new ways to incentivise contracts based on physical delivery. "At CME, we believe that the first building block to establish solid open interest should be a physical inventory," he explained. "So we have introduced a subsidy programme as an incentive to bring stock across. If you can do that then you're enabling banks to start financing the stock. It needs to be hedged and that helps to build the open interest. You're not directly subsidising the open interest but doing it from a more lateral perspective. We're trying this with the existing cocoa products and we are now up to about 7,000 tons of stock and it's growing."

Bradley told the audience he believed that in future the head trader is less likely to hold sway in dictating where trade flow goes. "It's much more likely to be the head of treasury who will be looking at his balance sheet and deciding the return he wants from it," he said. "If the products the traders are using are taking too much from that balance sheet to produce the return he wants then the head trader will be directed to put trade flow through particular exchanges' clearing houses or trade a different product."

The panel then looked at regulation as a driver for new product development. In particular, would MiFID's open access approach to CCPs or benchmarks help competition or would it help create new products?

Although Payne believed that open access could lead to fragmentation, Deel-Smith felt that open access would ultimately increase competition. "It should not stop innovation," he said. "If you do come out with something unique and innovative, you can always patent it and license it. With open access, you should be able to reap the rewards of netting post trade and collateral optimisation. Having to spread positions over various vertical silos is simply inefficient."

Payne's experience suggested that the opportunity to bring positions together had always existed but market participants had not always taken advantage of them. "You could have margined short-term interest rate contracts against long-term interest rates contracts on NLX," he pointed out. "Eurex have got half the open interest in the long end of the interest rate curve and they have also listed a Euribor contract, but people haven't shifted their Euribor positions there. If they want to get capital efficiencies that's all they need to do. People want capital efficiencies but they also want competition. I don't think you can have both."

Another driver of product innovation as a result of new regulation is said to be coming from the new capital requirements laid out by CRD IV and Basel III. Deel-Smith agreed that these were indeed affecting banks' ability to hold inventory. "If you look at the requirements for ten-day VaR and various other regulatory initiatives such as transparency, mandatory clearing, CCPs, trade reporting etc, there is a significant tailwind blowing towards the use of listed products and exchanges," he said.

Bradley pointed to his exchange's current range of repo products. "The fact that we had sufficient volume going

"People want capital efficiencies but they also want competition. I don't think you can have both."

Anthony Payne, Marex Spectron Pro Trader

through Eurex Repo as a cash product allowed us to build an index off the back of it," he said. "And with respect to the buy side wanting to find ways to generate cash for margin purposes for other parts of the business, we hope people will use those repo futures. It would be a good example of us taking a view on collateral and funding requirements etc and attempting to bring a new product in off the back of that."

The ownership of key benchmarks such as Libor and how they are controlled and managed has also come very much under the spotlight.

Deel-Smith pointed out that Libor had been in use for a long time and previously had been a public utility with a nominal licence fee from the BBA. "There are probably in excess of $850 trillion notional derivatives referencing Libor, including the swap market, listed derivatives Eurodollars etc," he observed. "Over several decades products out to 50 years have been built up on the understanding that they are referenced to a publicly available index. There were investigations into manipulation, regulators fined a few companies and it was decided that the calculation of the index should go out to auction. And the organisation which won the tender has drastically increased the licence fee. That wasn't necessarily a wise move. I'm certainly in favour of keeping

Libor as a public utility, along with the ISDA fix and the bullion fix."

Bradley, on the other hand, still believes Euribor to be a public utility. "It's still in place and now a much broader set of banks contribute towards the rate. I think that will have helped," he said. "And, of course, they're still willing to offer rates."

The panellists also discussed progress towards so-called 'futurisation', especially with respect to swap futures where there had been significant activity.

Eurex had already listed such products and Bradley outlined some of the issues surrounding them. "Because it is a deliverable product, you have to be a Derivatives Clearing Organisation (DCO) in the US in order to allow US-based clients to access them," he explained. "We are not registered as a DCO in the US at the moment, so that takes out a big chunk of your potential business. The devil is in the detail on a lot of these things as to what you can and can't do.

"There is not just one approach to 'futurisation'," he continued. "Looking at the size of the swap market there is room for a number of different products as there has been for a long time. What is holding it back is that banks haven't yet quite felt the pain of the rules concerning capital adequacy, risk weighted assets, leveraged ratios etc. That is when the reality of the bank's treasurer looking closely at the return on different products will hit home."

"If you come out with something unique and innovative, you can always patent it and license it."

Stuart Deel-Smith, Nasdaq NLX

"People now have to view the way they handle capital differently. For example, if you can't trade capital on a proprietary basis under the Volcker Rule, that takes away some of your potential return. It comes back to us knowing that new regulation is coming but it hasn't quite arrived yet. As an exchange you could put a huge amount of investment in, but you have to keep funding the new product until it actually does arrive. Even then there's no guarantee of success because everyone else is fighting over the same patch."

Deel-Smith believes there is still potential for such products but that the right one has not yet been launched. "Liffe brought out its swap note product around the turn of the millennium but it was probably before its time. And CME had a swap future a few years later," he said. "But the vested interests have protected their franchise. In the options market, banks get a large margin from value-add products, structured products, etc, which incorporate volatility and net down their risk. They feed off the listed volatility market as a way of hedging away their volatility risk. There is a symbiotic relationship between the listed options market makers community and the banks."

"Swap traders have indicated to me that 80% of their P and L comes from 20% of their trades with the other 80% earning nothing," he continued. "The swap future has certainly got potential for risk transfer and hedging in the interbank market where it's on the cost side of the P and L. Listed products are cheaper, they have less balance sheet impact and are easier and simpler to trade. But the OTC market will always have a place for hedge accounting and cash flow matching for the buy side. It remains a very lucrative business. Swap futures would not threaten that side of the business."

Deel-Smith also believes that many CTAs and interest rate traders would like to trade the swap curve electronically using high frequency trading or algorithms. "That would also be a lot easier via a futures-type product than the existing OTC market," he pointed out.

"There are also barriers of entry to the OTC market. One prime broker told me that it is not in their interest to cater for any fund with less than $2 billion under management. There's a wonderful opportunity for listed swap futures to cater for smaller traders, prop shops, hedge funds and the interbank hedging market. And that would actually support the OTC market. They can live side by side."

"The new swaps products are more complex so we don't let our traders go straight into them without understanding them properly," observed Payne. "At the moment every exchange is lining up a version of a swap future. Goldman Sachs has patented a deliverable swap future that was launched on the CME. Liffe, GMEX and Eris have also been innovative in this area.

"But many people are waiting to see when and if the new regulation will really drive the use of these products. Or will it be the more efficient use of margin that drives it? I certainly thought that when Dodd-Frank came in and mandated central clearing that volume would rocket. But it hasn't because dealers continue to have the bid/offer spread on the way in and the way out. They would do everything in their power to keep that opaque. So, while

"You will have the challenge of an entire industry exposed to volatility for the first time."

Peter Blogg, CME

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A valuable networking opportunity for the industry's clearing, operations and technologies communities

much of it will be driven by regulation, economics and the balance sheet are just as important."

To conclude the session, the panellists were asked if they had predictions for one particular product or underserved market that might become significant within the next five years.

Blogg pointed to the opportunity provided by the new environment of liberalisation in agricultural markets in Europe. "The changes to the Common Agricultural Policy will lead to an increasing number of commodities being freed up in terms of import, export, free-floating prices etc. The old caps are being removed. Then you will have the challenge of an entire industry exposed to volatility for the first time. They will need risk management instruments but will not understand how futures work, let alone anything more exotic."

Deel-Smith had no specific product in mind but felt strongly that there would be an evolution towards efficiency and meeting customers' needs. "At the moment people need too many systems, too many exchanges and too many CCPs," he said. "There has to be simplification for the end user."

Bradley hinted at the possibility of a hybrid credit equity type product. "We have been looking at that for a while but we're still not close enough to developing it," he explained. "And then going completely away from traditional financial or agricultural products, we're looking towards completely new types of products under the social media heading."

Whatever it is that drives them, it is to be hoped that the futures industry will once more enhance its reputation for innovation in the coming years.

Clearly, there are many different inputs into the product development process and as Payne concluded, "If exchanges produce successful products we will trade them!" ■

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FIA EUROPE NEWS

RESPONSES TO REGULATORY PAPERS AND POSITION PAPERS

August 2015 FIA Europe submitted its response to the European Commission's EMIR Review.

July 2015 FIA Europe, EFET and ISDA published a joint position paper setting our member concerns regarding the capital requirements regime for commodities.

June 2015 FIA Europe, together with ISDA, IA, AIMA and MFA submitted a letter to Commissioner Hill of the EC concerning EMIR Article 13 and MiFIR Article 33.

June 2015 FIA Europe, along with ISDA, EFET, GFMA and IETA, sent a letter to the European Commission, the European Parliament and ESMA, setting on our position on position limits, position reporting and the ancillary activities under MiFID II.

June 2015 FIA Europe published a review of the cumulative effect of European derivatives law reform, setting out the core issues and offering potential solutions to encourage further debate.

NEWS

August 2015 FIA, FIA Europe and FIA Asia announce plans to merge in the first quarter of 2016.

August 2015 Jonathan Faull, Director-General for Financial Stability, Financial Services and Capital Markets Union at the European Commission, replied to the ISDA-AIMA-FIA Europe-IA-MFA letter dated June 2015 to the European Commission on Equivalence under EMIR Article 13 and MIFID Article 33. The letter addresses the concerns raised by the trade associations on when counterparties may be able to rely on an implementing act of equivalence.

June 2015 FIA Global Launches Interactive Reporting Tool on CCP Risk.

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FIA EUROPE EVENTS CALENDAR

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- Capital, client money and other related issues.

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2015 POWER TRADING FORUMS

24 SEPTEMBER – REED SMITH

Topic: REMIT readiness

12 NOVEMBER – DENTONS

Topic: Collateral

2015 COMPLIANCE & REGULATION FORUMS

26 NOVEMBER – J.P. MORGAN

Topics to be confirmed

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JAZZ NIGHT – 12 NOVEMBER 2015
MERCHANT TAYLORS' HALL

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THE PRE- AND POST-TRADE ENVIRONMENT – THE IMPACT OF MIFID II

20 OCTOBER 2015, 5.00PM TO 8.30PM
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