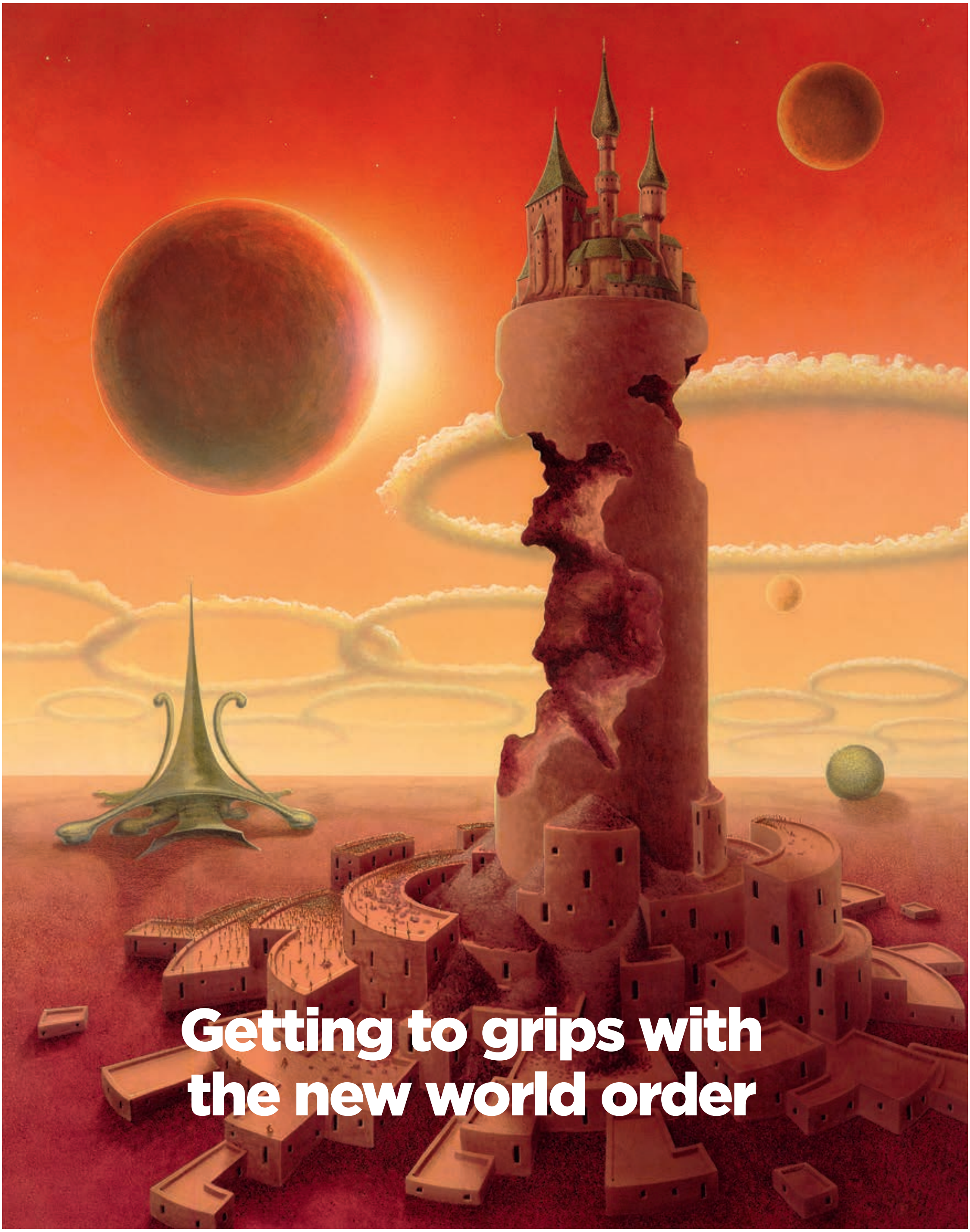
infoNet @ FOA

Pinch points in derivatives markets operations and technology

End user forum

Derivatives market infrastructure and the FCM business



Getting to grips with the new world order

ISSUE 1 | 2014

Welcome to FOA InfoNet

One positive trend to have emerged from recent market changes has been the more open and active involvement of the buy- side in the debate about the future of the industry.

Having previously been illusive and somewhat removed from the process, asset managers, pension funds, corporates and others have been heavily involved in dialogue on everything from transaction reporting to collateral management and segregation of accounts. The obvious reason is that they are at the heart of the transaction processes that regulators are seeking to make more robust and secure. And that these regulatory changes are having a direct impact on their use of derivatives.

One example was a recent story in an industry journal quoting a number of corporates which said that the problems they were encountering with new transaction reporting rules had led them to stop trading derivatives rather than fall foul of the new regulations.

The end-user panel featured in this report also illustrated the importance of the buy-side in ensuring the industry reaches consensus on how best to meet the challenges presented by regulators across the globe.

As Barry Hadingham, Head of Derivatives & Counterparty Risk, Central Investment Services at Aviva Investors, explained, the transaction chain has become that much longer, and within an asset management firm such as Aviva there are many different players around the table. Understanding the impact on those different client types, and then making sure that you represent a view which serves them all is key. A positive and perhaps unintended consequence of this lobbying effort is the increased amount of buy-side interaction. While firms have tried to take on the challenges on their own, they have quickly realised the importance of achieving a consolidated view.

The involvement of the buy-side will also be vital as exchanges, banks and intermediaries move forward with product and business development once the current implementation of regulations is complete and the industry starts to look again at innovation.

Currently, as a number of the speakers on the panel pointed out, they are too preoccupied with more pressing issues, such as reporting and segregation. But, as things improve, users will begin to look at things like optimising their margin or the use of their collateral. It would be in everybody's interest if this new and improved involvement of the buy-side were to continue, even after the challenges of today's markets have passed.

Emma Davey, Director Membership & Corporate Affairs
davey@foa.co.uk

January's InfoNet was sponsored by:

Platinum Sponsors: CME Group, eurex

Gold Sponsors: FFastFill, Fidessa, Trading Technologies, Traiana

Silver Sponsors: NASDAQ OMX NLX, OIC The Options Industry Council, omgeo

Contents

The InfoNet team

Emma Davey
Director Membership & Corporate Affairs, FOA
davey@foa.co.uk
+44 (0)20 7090 1348

Bernadette Connolly
Corporate Events Manager, FOA
connollyb@foa.co.uk
+44 (0)20 7090 1334

Philippa Hanman
Marketing and Communications Assistant, FOA
hanmanp@foa.co.uk
+44 (0)20 7621 2811

David Setters
Contango Markets
david@contango.co.uk
+44 (0)7710 271291

A report on the 18th FOA InfoNet:
Getting to grips with the new world order

From left to right: Richard Wilkinson, Steve Stewart, Paul MacGregor, Ted Leveroni, Paul Bauerschmidt, Bill Templer

Panel session 1:
Pinch points in derivatives markets operations and technology

Moderator **Richard Wilkinson,** Contango Operations

Panellists
Paul Bauerschmidt, CME Group
Paul MacGregor, ION Trading
Bill Templer, Faventus Consulting
Ted Leveroni, Omgeo
Steve Stewart, Trading Technologies

Richard Wilkinson This first panel is on pinch points in derivatives markets operations and technology.

The background to all of this is EMIR. This will be the key driver for operations and IT throughout 2014, with the emphasis on managing the additional workloads arising from EMIR. Two specifics come from the regulatory changes: segregation and portability aspects of the new clearing house offerings; and secondly, trade reporting. These will greatly increase the requirements for operations and IT infrastructures.

If we look at segregation more closely, the take up of the ISA structure or individual account segregation is still an unknown quantity, but it's certain that it will increase pressures on operations and IT departments due to the fact that they will have to do more reconciliations on a more timely basis.

Trade reporting, quite frankly, is a car crash and a train wreck. In both cases, IT solutions must be robust in order to cope with the extra workloads.

Let's talk about the trade life cycle from front to back. With respect to execution I'll pass over to Paul and Steve for their comments on where they see the pressures building. It could be from new exchanges like GMEX or CME Europe, market connectivity to SEFs and OTFs, Liffe's migration to ICE's trading platform, additional field requirements for UTIs, LEIs etc, and anything else.

Steve Stewart As a niche front-end provider, we provide software and execution solutions for electronic trading, so I'll deal with the front end of the trade cycle. We look at what that cycle entails. A trader will take a strategy, look to use his algorithm, and use his front-end platform or an API to push that order. So, for example, he'll buy 100 lots at NLX, that will then go through risk checks, then down to a TT gateway, whether that's hosted at a client's site or within our hosted environment. Then once that's happened, it will go down to the exchange.

Providing it has passed the risk checks, he will get an acknowledgement back to confirm it's working, it will come back to us, and then the trader will get a message confirming that his order has been filled.

It will then come into his risk system where he will be able to see it or a copy will drop into a third-party provider. So as simple as it may seem, there are actually a lot of components to it, and it all takes place in milliseconds. The challenge for TT is that we connect to over 40 different markets and all of those have different regulatory jurisdictions. And although there are guidelines within all those jurisdictions, we have buy-side clients who may not even be regulated, who will go to their FCM and ask for their trading to be implemented in a certain way. And that leaves the FCM trying to make multiple individual changes and to comply with all of those.

Things get further complicated for the FCM when multiple regulators try to push those changes through at the same time. It leaves a lot of uncertainty and makes it very difficult to push the changes through. Once that is done, it comes down to the technology providers like us to implement those changes, which will generally be under huge time constraints.

From TT's perspective, there's a lot of change, and if you look at all the exchanges we connect to, there's probably about 25 different platform upgrades to be done on an annual basis, and a lot of different parts within the lifecycle to attend to. We need to make changes to risk components and some of that work will move our business forward, while some will simply have to be done to keep us where we are.

A huge amount of change is taking place in the marketplace. It's a huge drain on manpower, resources and there are financial implications too. We haven't got a lot to show for that, we haven't moved our businesses forward, we're just treading water. Clearly we need to cater for regulatory change, but a balance is required and we need real guidance from the regulators. They need to be clearer in what they're saying to us, and they need to be conscious of the effect it's having on technology providers and FCMs. There's a huge amount of cost and resources involved and, ultimately, that stops us growing our businesses and working on new functionality, new markets etc.

It will help if they start co-operating across jurisdictions and standardising some of the ideas they want us to implement. Something like the LEI, for example, is a way forward in terms of standardising something that they want to implement.

These are the major pinch points in what we're doing currently and where we're struggling.

Paul MacGregor We face very similar pinch points. We provide front-end trading platforms, but also middle-office and back-office platforms, so I'll go a little further down the trade lifecycle.

In the last year, to be a bit more positive, one of our successes was that we wrote, or our clients asked us to write, to around 20 SEFs that had been established in the US. We provide trading access to those now and volumes are growing quite successfully. Those will ramp up as new rules come into play. The 'made available to trade' rule comes into play in the US in mid-February and we are likely to see a transition of the major standardised swaps onto screen trading. That's a big new opportunity for both us and our customers.

The other positive development has been the development of swap futures contracts. This has happened hand in hand with the mandatory clearing of swaps in the US. The dollar-based swap futures launched by CME and the Eris exchange have both been pretty successful. The open interest is at decent levels now. We're fully supporting those, and the next step from that will be things like generating strategy trading between swap futures and interest rate swaps. Customers are starting to ask us to do slightly more interesting trade types. That helps develop our software and it's driving some positives at the front end.

But there are always pressures. There are multiple migrations happening this year. In Europe, there is a big migration going on after the ICE takeover of Liffe and it's clearing and trading at the same time. Those are two big markets that we support and you have no choice

"We need to cater for regulatory change, but a balance is required and we need real guidance from the regulators."
Steve Stewart, Trading Technologies

but to get on with that. At the same time, you have all the regulatory requirements to comply with, with EMIR trade reporting coming into force on 12 February. The regulator is standing firm on that date. It means we have to go to our customers and ask if they want a transaction reporting module, which we can generate through our middle and back office platforms to allow them to generate a report to send directly to the trade repositories.

There's a very short timescale for it. We've been trying to get our customers interested in it through the third and fourth quarters last year but everyone hoped it would just go away. Now they've come back to work in January and realised that there are only a few weeks to go and they're asking, "What can you do for me?" Thankfully, we have our best people working on this 24/7 and we're pretty sure we can deliver what needs to be delivered in time.

The frustrating thing has been that regulatory requirements have been somewhat opaque and new information is constantly coming to light. For example, in December last year, we were purely focusing on new account types and new account segregation to ensure we could handle that in our existing back and middle office platforms. Then suddenly a new generation of UTIs jumped to the top of the agenda when virtually all the CCPs in Europe started to tell us that they could generate those UTIs, which we will have to create in our middle office platform. There are 11 new UTI specs we have to write to which we have to deliver within three weeks. The pressure is on. There are a lot of pinch points.

RW Regarding the SEFs and new exchanges you have been writing to, how do you prioritise that work? Is it purely based on customer demand?

SS Yes, it's a big balancing act. Obviously we have to look at the existing exchanges we write to. We need to balance the platform upgrades that we need to do for those with connectivity with the new exchanges coming through.

There are probably three parts to that. We'll look at a new exchange and ask if it will grow our user base. If we add them as a gateway, are we going to get new users or will that just add more connectivity to our existing users? We look at whether that exchange is offering something slightly different or whether it's doing exactly the same as all the others in a different manner. But, ultimately, it comes down to client demand and who's the loudest and how much demand there is for that connectivity.

PM I agree, and there's also a strategic element to consider. Will this new market add strategically to the benefit of my overall platform? Are there new strategies that I can generate from writing to that market or that product? Can I, for example, build market data aggregators across the SEFs? That is one reason we decided to write to so many SEFs, because we believe that that market will concentrate, and there are big benefits to writing to those market places. But it is really down to client demand. The exchanges which hope to launch this year, on the back of the EMIR regulation, will struggle very hard to get our attention. We have a lot of plates spinning as it is.

Bill Templer From an FCM point of view, that's exacerbated by the fact that realistically, you can probably only onboard about four to five new exchanges in a year at best. And when you have all these SEFs coming on board, as well as new exchanges and upgrades, that causes huge friction. So prioritisation becomes a very significant factor. There's a huge amount of conflict that the vendors face in this, in trying to be fair and yet still maintain their own commercial edge. It's a tricky balance.

RW Moving on to the post-trade area, where do you see the biggest pressures at the moment? And what are the notable successes from 2013?

Ted Leveroni We've got people from the front to the back on the panel, which tells me the pinch points are everywhere. That's not to say that at certain stages of the trading lifecycle, the pinch points are any better or any worse.

When we focus on communications between the buy-side and the broker, there are a number of pinch points. They fall within two areas, and the solution philosophically is the same. It's the allocation process and the match and the reconciliation, making sure you get the trade data right and if you're an FCM, how you communicate across all your clients – or if you're a client, how you communicate with all of your brokers. That's obviously challenging, especially when everyone has their own standard or their own solution. The solution should be a community solution and Omgeo is about the community.

The other area is post-trade communication. Everybody struggles with that because there is no standard that the industry has adopted yet. The clearing community standard, the client connectivity standard (CCS), has been identified and handed over to consultants, and they're saying we should go with it. The idea of a community solution between brokers and the buy-side is the right way to go. We talked about resources at a time when there are changing landscapes and requirements. If you can actually find a standard for that space, then the resource issue can be solved at once, instead of each firm having to come up with its own solution. That community solution needs to be found as soon as possible and we all have to have input, at a macro level and at an industry level.

We've been successful on the allocation side. We're bringing in new clients and we're trying to get them live right now with people committing to having a standard between the two groups. What that will bring, and it will be helpful later, is trade data reconciliation and making sure those trade details match, that they're accurate. Then all the processes that go on after that, the reporting, the risk analytics etc. can be kicked off more quickly and accurately, because you have that in place.

But I think the idea of the industry getting together behind the concept of standard clearing broker statements, the philosophy of a community solution, is the answer for most of the industry's pinch points, wherever they may be.

PM We've spoken with all of our existing Eclipse customers about whether they want to use our back office platform to generate the transaction reporting that has to be delivered by 12 February. We will deliver those individual reports to customers. It's a very short timescale but if clients want it we will do it in a standard format, a single CSV format. Admittedly, we haven't undertaken to write to every single spec of every trade repository. That would be too much work to do, on top of the other work in this very short timescale. A single CSV format is quite sensible given the way ESMA has designed the report. If your TR can't read that then you need to talk to them about what sort of TR they are. CSV files should be fairly easy to understand in the ESMA format. But it is, again, a big squeeze to do this alongside the creation of the UTI in the middle office.

BT The standardisation argument has been going on for years. The FOA and FIA got together some years ago to see if some of the exchanges could jointly look at things they don't perceive as having competitive advantage. There was almost nothing that they would agree to standardise. I'm not just blaming the exchanges, because the FCMs probably look at it the

"The industry getting together behind the concept of standard clearing broker statements, the philosophy of a community solution, is the answer for most of the industry's pinch points."
Ted Leveroni, Omgeo

same way. Software vendors will look at these things and think they may have a better platform which gives them a unique advantage.

Standardisation will only happen if an industry body like the FOA pushes it along because there are too many vested interests otherwise, and too many commercial drivers that the FCMs and exchanges have, and so much pressure from other work that they have to do. I can't see them agreeing to spend a lot of time rewriting things that already exist to put them in a standard format. This will continue unless there is a concerted cross-industry push or unless it's driven by regulators, which may be the other answer.

TL The optimist in me says that it could be driven by a crisis. Looking at outsourcing on the buy-side, it wasn't until there was so much cost pressure on them that they really embraced outsourcing their back office operations. In the early 2000s, only a handful of investment managers were outsourcing their back office because they thought it was a differentiator for them. Now, through recession, you have a lot of investment managers that have outsourced their back office operations, and we are starting to see brokers that are doing it as well.

The investment managers are asking, "How do we reconcile, how do we do this, how do we do that, really it doesn't make me a better money manager, does it?" Maybe the silver lining to all of these challenges that we have with the economy, Dodd-Frank and EMIR etc is

that it will eat up so much resource and be so difficult for everyone to comply that they will have to co-operate and be more selective with what they do, with what really differentiates them. Perhaps, in the light of all this, those that don't want to standardise will be a little more muted.

Paul Bauerschmidt Our focus here has been on client enablement and client impact. In the US, we had three waves of regulatory reform; the reporting, the clearing and now trading coming up next month. With each one of those you have to think about what information needs to get out to the community, whether it's a risk vendor, a trading front end supplier, clearing firm or the end trader. What information do they need to report or clear or trade on a swap execution facility?

Anything that we adjust as an exchange affects everyone in the community. With regard to standardisation, we've been trying to push for more standardised interfaces, especially with the FIX community. From our clearing house we primarily support FIX although some select FPML for interest rate swaps now. We try to push standardisation wherever possible. That is absolutely where we want to go, but with the emphasis on client impact.

BT Ted is right. More of the FCMs are looking at the IT budget for next year and are recognising that 80 or 90 per cent of it is consumed by regulatory work and mandatory upgrades etc. They feel there must be a better way of doing things or they'll have no budget left for their clients or their innovation. That is a big problem for many firms. They are being forced to look at where they can outsource and use a more standard platform.

PM One of the issues with standardisation, certainly for the major exchanges and the leading vendors, is that they are all keen on standardisation as long as it's their standard. That acts as a brake on true standardisation across the market.

RW I don't quite agree with that. For me standardisation has often meant going to the lowest common denominator, to the simplest thing that everybody can possibly use.

That's fine for people who want to go there. But in my experience, people always want bespoke development and specialisation. Ted said there is no standard for the generation of client statements because everybody wants to do it in a slightly different way. Your customers ask for bespoke development. You can have standards across the marketplace, but people will always ask for bespoke work. I don't think we'll ever get away from that.

TL The key is, how do you define what can be standardised and what should be bespoke? You can't tell people what car to drive, but you can tell them some of the rules you want them to follow. Everybody should look at what they do and ask themselves if it's possible to do them in a different way. And if it gives them a competitive edge then they shouldn't standardise that piece. They have to revisit that decision constantly because what can be a competitive advantage can, after time, become the same for everybody. But if you decide that something doesn't really give you an advantage, then it should be an area to standardise. The most forward thinking firms will have a lot of bespoke work and do things completely differently to everyone else. That's what makes them good, but they can embrace some standardisation in certain areas where it doesn't differentiate them.

SS From TT's point of view, we have a limited part of the transaction cycle, but we need to work with other parts of it and standardisation really helps us in terms of passing that through. I question if some exchanges actually get a competitive edge from some of the mandatory changes they make. The knock-on effects from those are pretty big. Having to have the manpower to implement them and the associated costs ultimately stops us growing our business and working towards the other things we could be working towards.

PM It does take away a lot of the time you need for

"You can have standards across the marketplace but people will always ask for bespoke work. I don't think we'll ever get away from that."
Richard Wilkinson, Contango Operations

innovation. You do need time to generate new business and new things, to allow you to present new products to your customers rather than having to deal with a mandatory or regulatory upgrade. Those take up 90 per cent of our time at the moment. Thankfully, I think CME is coming over here with a standard that already exists in the US, so it isn't an enormous amount of work for us to support their new marketplace

BT If you look at the top 20 FCMs, the difference in the quality of the development phase they're in is enormous. The best do see competitive advantage in their technology because they're much further ahead than the ones at the bottom, so they will always have a vested interest in doing things themselves and being able to offer bespoke solutions. It doesn't help to push the FCM community together, so it's not helping standardisation, but it is a reality. There is a vast difference between FCMs, with respect to the technology they have and their capabilities now.

RW Paul, how will CME cope with the increase in collateral flows from the take-up of individually segregated accounts or the increase in omnibus segregated accounts that clearing members will demand? Have you tested your treasury and banking systems so you know you can cope?

PB Yes, absolutely. When I joined the exchange ten years ago we had just one or two accounts per clearing member. Twenty-five accounts was a big day and now if you look at the exchange, we've got over 20,000 accounts registered. That allows each clearing firm to have many different houses, but obviously includes all of their customer business and the various segregation models that they might have collected.

When we started to implement the regulatory reform for clearing of OTC swaps we had separate OTC accounts, so as we've introduced cleared interest rate swaps, credit default swaps and non-deliverable forwards, NDFs, these are coming into new account types and new customer categories for us. We've really ramped up our support for the asset manager business model along those lines, to facilitate the managed fund type of approach. That is segregated in these new account categories.

RW And are your communications gateways all automated? Are you offering GUIs and APIs?

PB The interface that we offer to our client firms always has a very robust FIX interface as well as a web GUI to facilitate the management of funds and moving of collateral.

RW With respect to trade reporting, where do you see the key challenges?

PB It's going to be a rough transition, but we're positioned to assist. We've filed to be a set of global repositories. We have a swap data repository in the US that's up and running successfully. We're booking a number of different asset classes through our US SDR today and we have a European TR. We wanted to make sure that for anybody who uses the exchange, whether for trading or for clearing, we could facilitate the use of our trade repository. The delegation aspect is something we've paid a lot of attention to, in asserting that customers who use our markets are automatically taken care of within the repository. Obviously, if they want to use their own, that's fine as well. We've built up our staff for the European TR with a CEO and a staff of around ten in London. Operations are managed from Chicago, but operational aspects are being managed locally.

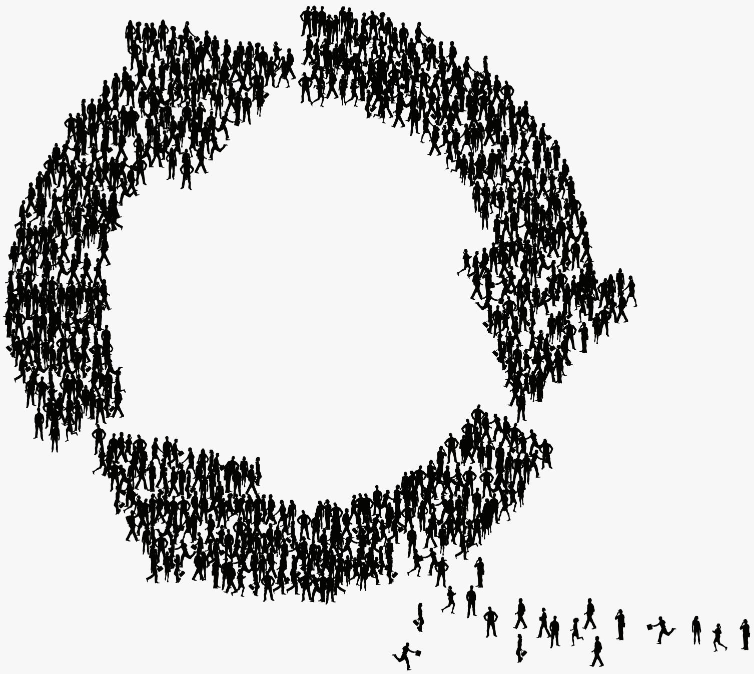
RW And because TRs in the States are only for OTCs with single-sided reporting whereas the European TRs are for all derivatives including ETD, and it's double sided, do you have the capacity to handle that complexity?

PB We do. We fully support the matching capabilities within our TR, but whether you're using the exchange to trade or to clear we are managing the match in some form on both sides so we will have that information on the way into the TR.

RW Bill, where do you see the key pressures in complying with the reporting requirements?

BT People have just woken up to the fact that this is really happening, so the pain is frankly self-inflicted. But the lack of clarity around exactly what's required, the changes to the rules, the lack of real understanding as to what really will happen with these trades when they actually get them, just makes the whole thing feel like a complete pain and nobody really wants to do it.

However, it really shouldn't be that hard to be able to deliver a set of trades each day. Most FCMs already do some trade reporting for the FCA or other organisations. So with the UTIs and other identifiers it technically shouldn't be that big a deal. It's the difficulty of having multiple repositories and really understanding what you're going to do with the trade that is causing problems. The regulators have probably done the right thing by saying, "You've got to get on with it" because, if you defer it, it's one of these things



that people will put off until they're made to do it.

It may be a bit of a mess to begin with, but it's probably a smart move. You've got to get on with it and manage the issues. It will be forgotten about fairly quickly once it's all implemented. It becomes routine once you're up and running. It's the knowing what you're doing that seems to be the problem.

RW It would be interesting to know how many firms are going for an enterprise-wide solution with a selected TR and doing their own reports, versus how many have opted for delegated reporting.

TL I've heard from clients that many are starting with delegated reporting, but they don't see that as the final solution. They realise at some point they'd like control over it but it's something they can put on the back burner by delegating and then get to it when there's less pressure on. The percentage of delegated report entities will probably decrease over time. But it's also possible that some firms will be thrilled with delegating to their broker and stick with delegated reporting. It's going to be a moving number for some time.

BT Are many brokers actually offering delegated reporting? I thought most were trying to avoid it.

TL Yes, they are trying to avoid it. I don't know what's in it for a broker to delegate reporting. They can charge, but will they be able to charge enough to cover their risk? It just doesn't seem like a business that a broker would want to be in.

BT If a clearing member offers delegated reporting the legal terms may specify that the broker has no responsibility for anything that happens once the transactions are reported. It is possible the buy-side might have a blinkered view that if they delegate, the problem goes away, when in fact the only problem that goes away is the transmission. The responsibility and the reconciliation of any breaks will still lie with the end customer, whether that's a second-tier bank or broker or fund. People seem to be in denial about what delegating reporting means. The other issue is, if you've got more than one broker, and those brokers use different TRs, then how do you, as the end client reconcile the total of your reporting requirement when it's across two different TRs? Potentially you need a log on, even if it's 'view only', to multiple TRs.

PM There is a bigger issue which is that the whole point of reporting into the TR was so that the regulator could look across the market and have a view of risk. By allowing there to be multiple TRs, they've made their job virtually impossible. Now to look at one big end user's position they will have to look across all the TRs where their clearing member may have deposited their transactions on their behalf through delegated reporting which will involve different UTIs. How am I supposed to track those down? The regulator has created a very difficult position for itself, if it wants to fully track the risk of one big end user.

RW The latest information is that from 11 February you have to load up all your open positions. Firms will be able to report their positions at close of play on 11 February but with no mandate to report for 90 days. A trade book does not measure risk and it's only when the position reporting kicks in and the national authorities start querying the TRs, all six of them potentially, to get an idea of the risk of a particular counterparty in their jurisdiction, that you will be able to get an idea of where the risk really lies.

TL This is one area where we might collaborate and have one warehouse. To have one depository seems to make sense. It makes it easier for us and easier for them.

RW Yes, although over the course of the next 12 to 18 months the number of repositories will probably go down from six to two or three, and it will depend on who has the deepest pockets or who's not getting any flow through it to help pay the start-up costs.

On the TR front, in terms of managing the mismatches, it's fine to send your report off, whether it's delegated or you're doing it yourself, but there does appear to be some confusion about what information will come back from either your TR or your counterparty's TR if the trade doesn't match. I had heard that the TRs would report back if a trade is mismatched, but not tell you what the other side has put in.

PB All I can add is that we will notify anybody who is registered with us over mismatches. I don't know what level of detail we'll go into within the context of that mismatch. There's also a subtlety around whether it's a delegated report into our TR, in which case the end user wouldn't even be a registered constituent of our TR, and so we would notify the delegated party, to the extent that we would know who anybody was at the other end of that.

PM A regulatory light bulb seems to have been turned on regarding this. As a result of delegated reporting, we could be having UTIs which differ across the same transaction. Therefore the regulators floated past the clearing houses recently the idea of introducing yet another identifier called a TRN. That TRN would be the same throughout the trade lifecycle. I think there was a European Association of Clearing Houses meeting recently where the CCPs decided that it's too late to have yet another ID put into the reports or to generate yet another idea at this late stage. I'm very glad they did because it would be a real struggle for us to deliver it. The regulators have suddenly realised that due to delegated reporting, there might actually be more breaks than they have considered.

It's just one example of the unintended consequences of a new regulation. We are predicting we will have to do regular regulatory software updates for our customers incorporating the latest EMIR requirements. Obviously the first drop is in time for the trade reporting deadline and we hope to deliver a few weeks before that. We think there will probably be at least two more this year and possibly every quarter there will be an EMIR release or a normal release update containing an EMIR element because the regulators will be constantly looking at what they've implemented, and whether they need to make improvements.

RW Paul, without divulging any trade secrets, what methodology is ION following for UTI generation for your FCM customers?

PM It's different actually, across all the CCPs. The CCP gives you up to nine fields from where you can collect the data in the middle office. You then generate this UTI and pass it on to the back office. So we have to build for up to 11 different CCPs, currently, who have published calculation methods for UTIs. We're obviously struggling to get those done by 12 February. There is one CCP, ICE, which is generating all the way through from front to back, which is useful because it means we don't have to do anything. But with other CCPs you get the data to construct the UTI from your middle office, then you pass it on to your back office.

RW So you will use each CCP's methodology, construct the UTI for your clearing member from that and then use a flavour of it to produce a new UTI that the clearing member can pass to its customer?

PM Well, no, because if the clearing member is doing delegated reporting on behalf of its customer, then it generates its own UTI to give to its client. It's slightly different.

RW There are other regulatory challenges for 2014 that don't fall into that trade lifecycle category. Documentation is one of those. The FOA has produced a revised set of its 'terms of business' with the new clearing addendum for ISA elections. This will be a living document as the CCPs get reauthorised. Where do you think that will have the biggest impact? Clients will get used to the fact that the FCM's clearing sales and legal people will constantly be on the phone. How much effort will be involved? Or will customers shy away from the ISA structure and just prefer to leave it as it is?

BT I think they're a bit conflicted at the moment. When you first mention individual segregation to a lot of clients, it seems a very attractive proposition. If you'd had the conversation a couple of years ago when there was severe concern about counterparty risk, more people would have wanted to do it.

They've got so much on at the moment that it's become less of a priority, and the documentation issue is just one of those things that will affect clients and FCMs quite significantly. The resource requirement for either 're-documenting' or changing the documentation for thousands of clients is yet another burden that people don't really want to address. If you can avoid it and use that time and effort to do other things, then that probably helps a bit with prioritisation. I'm sure some clients will get onto that but I don't think it will be a hugely popular implementation.

TL If you had asked the banks in the States what was the biggest issue for any Dodd-Frank implementation, they would have said legal resources for the new clearing agreements and OTC derivatives. That took longer than anything else. Segregation won't happen in a vacuum. Firms need time and legal resources to work on new agreements and for operations people to tell them what the impacts are of some of the things you are agreeing on. It will happen at the same time as OTC clearing agreements are renegotiated and executed. So anything that requires more legal resources will push up against the supply issue.

RW Do you think GCMs will price by individual account segregation at an appropriate level, or will they try and use it as a competitive tool to get more customers?

BT I hope this is a good opportunity for FCMs to look at pricing generally. At the moment the risk/reward for clearing business is not anywhere near where it should be. People are struggling with zero interest rates, with lower volumes, with tougher competition, with higher costs and so on. Prices have been squeezed to a ridiculously low level and when you look at the capital charges that are coming in they will have to re-price. This is a great opportunity to accept the world has changed and to price in a more realistic way to end clients. If firms don't do that, they've really missed a trick, because the lack of profitability on the clearing side is a real threat to the whole industry at the moment, unless the FCA really looks at it and concludes that we have got a price commensurate with the risks and costs that they're incurring.

SS There's certainly a lot of costs coming in, but how do they differentiate that pricing from their competitors. How do they differentiate what they've got against what they have to do anyway?

BT A lot of FCMs are spending a lot of time looking at the real cost of clearing and having conversations with clients that they have a good relationship with. I think many clients do appreciate the pricing issues, whichever clearer they're using. It's got to the point that the margins that FCMs are making are so small that if they set out their specific costs and explain what they are incurring that their margin on top of that is only 'x', that clients will understand that. Nobody really wants to be the first, that's always the problem. The Swiss banks have been driven to this earlier than others because they were early adopters of the Basel III rule, so it's already happening and I've heard that several FCMs are having those conversations with clients.

It's about explaining what your proposition is as an FCM, that it's not just about clearing a trade, it's about the ancillary services that you provide and what your bank does as a broader relationship. There are many factors but business has to be priced in a way that actually allows FCMs to make money. At the moment that's a bit of a struggle.

"The lack of profitability on the clearing side is a real threat to the whole industry at the moment."
Bill Templer, Faventus Consulting

RW It's interesting that you've mentioned that Bill, because FCMs are beginning to talk about moving away from a pence per lot structure, because it doesn't accurately reflect the capital charge associated with default fund contributions, initial margin etc. They are starting to look at it more from a risk point of view. The bigger the position, the more you pay, because the more open interest, the higher the margin, the higher the default fund contribution and therefore the higher the capital charge.

BT The introduction of OTC clearing has helped that process. There was a big problem early on when many FCMs who wanted to do OTC clearing went to the banks and wanted to get people signed up as quickly as possible. Frankly, they are recognising that they mispriced it. But at least they went through the component parts and looked at those in a way that created some transparency. Costs are clearly being incurred here that you can't avoid, and there's no reason at all why an FCM should be paying those on behalf of an end client. So, if you had that transparency around what the components are, then you do come down to how your firm is different in the way it looks at these issues. In the end, prices will only go one way, and it's not down. I think they have to change.

Question from the audience Given all the regulatory aspects and the extra workloads, are you likely to be putting up prices to your own clients?

PB We try to price as appropriately as we can to the customer segment in question for the product in question. In the case of the cleared interest rate swap, what worked to our advantage was, that in the case of our core futures markets, we were able to broadly maintain, with some incremental upward trend, those price points, and in the case of OTC clearing, it was a new structure and we were trying to price it around those futures equivalent products.

SS We have dropped our prices and part of being able to do that is having streamlined the way we're priced in a changing market. We've got to look for even more efficiencies. We've got multiple networks, whether it's at our hosted solution or at a client, where they take the TT software and have it on their own network. We've got a multi-broker network as well. The challenge is to see how we can reduce some of those and pass that benefit onto the customer. To make that more efficient and hopefully reduce some of the back end costs is probably the biggest challenge from our clients' point of view.

TL We are pushed by our clients to decrease prices. We've done so in a number of instances because the banks and investment managers need to make rising costs up somewhere. So our prices have come down, I don't see them going up any time soon.

A lot of these changes give us new opportunities. We are investing in new products to bring more value to our clients. That's where we can grow our business.

BT There's been a history of the vendor community being hammered by the FCM community on costs. Anybody under pressure for their own costs will always look at where to cut them. But you have to differentiate between what I'd consider market standard development and how you price those, versus additional work that isn't standard but is to benefit the FCMs.

Coming back to the original point about choice and prioritisation I think all the vendors have to be as tough as they can be with FCMs about pricing things correctly, in the same way that FCMs have to be.

TL I agree. As a champion of standardisation and of community, over time, our services are looked at as a commodity and not a differentiator, so we try to identify and then articulate the real value that we bring. We're not just a protocol that is agreed upon and messages. There's infrastructure and security behind it, there's disaster recovery etc. That's not an easy conversation with a banker or investment manager because, for example, how much value does your telephone company bring you? You're used to using them every day, so you stop valuing it. It takes time and you need to articulate what the real value is.

PM We will continue to price appropriately for services that we provide. That doesn't mean we're going to be cutting or increasing, we just price appropriately depending on our costs. We try not to get hammered by the marketplace. All that does is consolidate the industry, and you're left with less choice. Within ION now, you have Ffastfill, Patsystems, Rolfe and Nolan and other technology providers. You've seen banks and FCMs consolidate, and the fact that vendors consolidate is just a result of what's happened in the last five years.

"One benefit of consolidation is that we can leverage the multiple networks and exchange connections that we have across the group."
Paul MacGregor, ION Trading

One benefit of consolidation is that we can leverage the multiple networks and exchange connections that we have across the group now. There's no point in writing to NASDAQ and NLX three times. You should write once and you still have the choice of different trading access points that the client wants to use. That's something we'll be doing very aggressively over the next year or so.

BT Part of the reason for consolidation was poor pricing in the first place. They didn't battle for their own value, they succumbed to the hammering that they got from FCMs and died as a result, or were reborn somewhere else in a different guise. That's less of a problem now. Looking at the two back office providers, GMI and Rolfe and Nolan, as they were, I maintain it was probably the only duopoly in the world where nobody was making any money a few years ago. And yet, things have changed and probably improved. Maybe there is more competition now but it has been a struggle.

PM New technology is probably generating new competition as well. One reason why ION pursued Ffastfill was its cloud-based computing and its software as a service. It wasn't one of the vendors that was being hammered into extinction; it was actually doing very well. There are success stories as well, if you can get your technology and your service just right. But you've got to price appropriately, to stand up to your clients and let them know that just because you're at the end of the chain, it doesn't mean you need to be the weakest link.

SS I agree. If you stand your ground and keep that price point, you're able to deal with a lot of the cost. Ultimately we're trying to make money like everyone else and if we can cope with what is endless regulation coming through, endless new upgrades etc, then we won't be able to innovate, find new ideas, take on new exchanges, and that will stagnate the market. We're in a tough market as it is, you don't go and add to that problem by stopping innovation, and those price points help innovation and help us to survive.

BT On the operations side, the new back office platforms, the technology that's coming on board from ION and the new SunGard GMI system will make a big difference to our industry. It may not happen over the next couple of years but the dramatic shifts in how you process trades on a much more automated, work flow basis could significantly reduce the costs for FCMs over time and that is a real positive.

RW And reduce the pinch points we see in operations because there are still many manual processes.

Question from the audience I understand clearing brokers plan to offer UTI generation for clients as well as CCPs. So it seems there will be no 'best practice'. Perhaps the FOA could help out here?

PM I think that's just a result of having to report both exchange traded derivatives and OTC in Europe. In the US you are mandated to report only OTC trades because ETDs are cleared and already being reported to a regulator. But ESMA has decreed that ETDs must be reported as well, double sided, not singled sided. There are multiple ways of generating UTIs, you're right.

RW I heard that one big UK investment manager has outsourced its ETD trade reporting but is keeping its OTC reporting in house. We can speculate on the reasons, but my personal view is that it's because for ETD, the clearing broker knows the allocated accounts where the position is going to end up, but for OTC, keeping it in house means any intercompany trades within the investment management group are hidden without letting the executing or clearing broker know exactly what's going on.

That's why people are saying they will offer UTI generation and then offer the reporting, because they're seen as being independent. Although there should be a proper Chinese wall in place, there's still the perception that, if the clearing broker is generating all the UTIs for all the intercompany trades, then they'll know exactly where you are when you phone up and ask for a price.

Question from the audience Richard, to give a sense of what might happen in the immediate future do you think that some brokers will simply take the fines or will the regulators not apply the fines? Associated with that, can the panel give us an idea of how well they think the buy- and sell-side are prepared for trade reporting and other upcoming changes?

RW I certainly don't think the regulator will backtrack. There was so much lobbying, especially by the FOA, but the Commission was unmoved so I don't think the regulator will stop this from happening.

However, I don't think the FCA will come down very hard on firms that are making best efforts to comply. They may censure them or fine them but personally I don't think that will kick in for three to four months.

PM I agree. The view of the regulators is that things are quite opaque and they want firms to move forward on a 'best efforts' basis. But our clients want to be compliant fully from day one. They are taking it very seriously. They accept that 12 February is the date.

TL From conversations we've had, the 80/20 rule applies. The largest investment managers have focused on what needs to be done and typically they have more leverage with their brokers, who will do more work for them, and so they're more prepared. In terms of volumes there's a lot better state of preparedness than in terms of numbers of entities being ready. It's not just their fault. In the US, getting OTC clearing brokers up and running on documentation was delayed because of their resources and legal resources. It's the same with reporting. A number of firms are having a hard time dealing with their trade repositories or with internal issues to get ready and so, whatever side you're on, whether you're a repository, on the buy-side or the sell-side, everybody is struggling with resource constraints. It's going to cause a large number of managers to miss the deadline.

PB From our perspective, we just want to make sure that anybody who trades or clears on the exchange is taken care of with respect to that leg of the report. That's certainly what we've been facilitating with our TR. Our key focus is to make sure that's as seamless as possible across the transition.

BT I don't see any reason why there should be a change. It will just progress and most people will be in reasonable shape for it, and those that aren't will have a plan to fix it and will fix it. It might be a bit messy but I think it will get fixed in time.

From left to right: Richard Metcalfe, Steve Grob, Ricky Maloney, Barry Hadingham, Hester Serafini, Adam Pacey

Panel session 2: End user forum

Moderator **Steve Grob,** Fidessa

Panellists
Barry Hadingham, Aviva Investors
Ricky Maloney, Eurex Clearing
Adam Pacey, M&G Investments
Hester Serafini, J.P. Morgan
Richard Metcalfe, Investment Management Association

Steve Grob 2013 was the year in which we had to assimilate an awful lot of regulatory change from Dodd-Frank, MiFID II and EMIR and people have had to come up with plans as to how to mitigate and manage those changes or, better still, take advantage of them.

And if 2013 was the year for planning, then 2014 will be the year we see if our plans were any good or not. Our panellists represent the end consumers of everything that we produce, whether we are technology providers, brokers or exchanges. And, with respect to regulatory change, some key milestone dates are just weeks or even days away. Finding out what the buy-side is really thinking and doing, then, seems like a good starting point to try and validate some of those plans.

I'd like to begin by getting the buy-side perspective on these market structure changes and what some of the consequences are likely to be and then end with some predictions about how we think things will ultimately shape up.

Barry, do you feel perhaps we're coming to the end of the journey and what are your thoughts about where that journey is taking you?

Barry Hadingham I've probably spent the best part of four years looking at EMIR. We've come a long way in terms of working out the things that we need to do to comply with the regulation. The regulators have also come a long way in terms of working out the things that they need us to do. We've gone through all of the building blocks and we've got to a point where those building blocks are largely laid out for us. Now we have to assemble them in the correct order that the regulators expect. I don't expect there'll be any further delays to the timeframes that have been set out. So I would firmly expect trade reporting to commence in February and the clearing houses to be approved, and mandatory clearing to start to roll from there.

SG And what about you, Ricky?

Ricky Maloney Yes, I think Barry's right. I'd add that there are some distinct differences between what the regulators intended when we began the journey some four years ago and what we see now. It's not entirely different, but there are differences. And I think that's down to market forces. With a lot of it common sense has prevailed because it's a smart business we're in, and evolution would probably have taken it there anyway but this enforced regulation has given it the push that it needed and a lot of unnecessary fat has been trimmed along the way.

SG Would you say generally that the buy-side welcomes the majority of these changes or is that going too far?

RMa Absolutely not, no. Going back to the very beginning when you first realised what the changes would be and what the impact would be on your business, it struck you as a tremendous change. One of my old bosses told me that we may as well put the keys through the letterbox on the way out, because we can't afford to be in the OTC business any more. But as things evolve and you look deeper into them, you do start to see some efficiency for your business. If you 'futurise' the OTC industry, for example, there will be efficiencies. It also makes you look at your entire value chain. Are you, for example, managing your collateral in the most efficient manner? Probably 99 per cent of firms were not, but if you ask that question today, many of them are.

SG So you're saying that responding to all this regulation has probably been a good thing?

RMa There have been some good outcomes, yes, but I wouldn't say overall it's a good thing.

SG Adam and Hester, what are your thoughts?

Adam Pacey I don't think the journey's over. I absolutely agree that 2014 is the year of putting those building blocks together and making sure that everyone's compliant. 2015 will undoubtedly be about the market looking to optimise arrangements as the regulations bed in and the infrastructure and participants grow in sophistication. This will be true of reporting but especially so in relation to collateral management.

Hester Serafini A lot of our role in OTC clearing today is acting almost as consultants to our clients as they transition from the way the market used to be to the new world order under the new regulations. As there is no mandatory clearing in Europe yet, many of our clients are not actually clearing, yet they have selected us as providers and want us to help them through that transition.

Over the past few years a lot of energy has been spent trying to interpret the regulations and to give feedback to the regulators. Now things are coming to a close, particularly with reporting, which has been quite a challenge for many on the buy-side. There was hope that it would be delayed and that it wouldn't apply to futures, it would just apply to OTC. But it has turned out that it does apply to futures and it has not been delayed. It has been a very tough exercise to help get everybody ready for that and it's occupying a lot of our clients' resources.

Then there are the new segregation models, which a lot of people are spending time on, because as a buy-side participant you have fiduciary duty to make the right choices for your clients when these are being offered. With the way EMIR is written, as soon as a clearing house gets re-authorised you have the choice of different segregation models. You can be in an omnibus model or in a better level of segregation, and you need to make sure you make the right decision for your investors in that respect. There has been a lot of evolution in that space together with a lack of clarity, initially, because unlike the US, where there is only LSOC that's mandated by regulation, in Europe – EMIR seeks more differentiation and looks for the opportunity for clearing houses to come up with the best possible models of segregation. So the clearing houses competed and came up with different models that people then had to evaluate to figure out the comparative benefits.

It's been hard for the industry to get those segregation models properly implemented in the short amount of time available, because clearing houses had to submit their application for reauthorisation by September, and had to have the segregated model in that version. And because the authorisation process is not always transparent, the clearing brokers and the end users didn't always know how the segregated models worked. That has created a lot of work for the industry, trying to figure out what the right choices are. There still are quite a few steps, both at the clearing houses and at the clearing members that may be manual initially. There have been a lot of things to work through but although it has been forced into a very compacted timeframe, I do agree that there will be

"Although it has been forced into a very compacted timeframe... there will be benefits from this for the industry as a whole."
Hester Serafini, J.P. Morgan

benefits from this for the industry as a whole.

Richard Metcalfe It's about getting over the immediate hurdles at this stage. There's still a lot to play for. A simple example would be that we don't really know where the pension fund temporary exemption will end up. That will run to at least the middle of 2015. There's work going on at the moment to see how the arrangements for pension funds could alter. It highlights a very important point – that it's not just the asset managers you're talking about; it's also their clients that you have to look through to. That raises the question of the relative attractiveness of cleared versus non-cleared, as well as the 'futurisation' question, which will be very important. And the collateral efficiencies are going to be very important within that. Clearly the ability to achieve greater offsets and use collateral more efficiently, as well as processing every individual piece of collateral, will be an important commercial consideration, as well as an operational one.

SG There has been a lot of lobbying of regulators in Brussels and Washington by all sorts of industry bodies. How well do you think the buy-side has argued its case on the regulatory agenda?

RMe Whether you call it lobbying or technical advice, I think we're still in a world where the burden of proof is on the industry to say why something is wrong. And that has important implications for any future pieces of legislation. To take a balanced view, if you look at EMIR and the rules on segregation, they're a good example of sensitivity to buy-side concerns. So you could very easily argue that the glass is half full on that, but there's a long way to go. And the process around MiFID II has raised some interesting questions about the relative advantages enjoyed by exchanges as compared with off-exchange business.

SG If we switch asset class and look at cash equities, for example, there's a fair degree of disappointment. The sell-side and the buy-side are united in questioning the value of some of this regulation. From a derivatives perspective, are there some fundamental areas that you would take issue with?

BH Well, to Richard's point, the burden of proof is still on the industry to say why things are wrong. There was a meeting at the FCA in December, to discuss the front-loading obligations under EMIR, which are extremely problematic for everybody. And the FCA was saying that banks manage risk and uncertainty every day so why can't they manage this one? There are some bits that really are problematic that we haven't managed to get to the bottom of, that just being one example.

SG Any other examples?

RMa I think ETD reporting, actually. That really took me by surprise, and I think it did all of us.

HS I agree. Especially, the two-sidedness of the reporting.

AP The transaction chain has just got that much longer. There are many different players round the table with ideas and views on how this can and should work and understandably everyone wants a voice. From the position of an asset manager, however, we are representing a multitude of different clients and need to ensure that they are all represented in the lobbying efforts. Equally as striking and a positive, perhaps unintended, consequence is the amount of buy-side interaction that has caused as firms very quickly realised that through the IMA and other means, we needed to have a consolidated view. I've certainly found those forums, with the clearing houses or through the IMA, useful and positive.

SG There's a lot of debate about extraterritoriality and regulatory imperialism. At a day-to-day level, is that something you worry about?

BH It's a real problem. We don't have clarity on how things work on a cross-border basis. If you look at EMIR, in the absence of equivalence with other jurisdictions you default to your home regulation. If, like Aviva, you are running operations overseas, that is a real problem, because essentially you have to comply with EMIR, but then at some later stage when that equivalence is there, you have to switch back. That makes no sense.

HS It's starting to be problematic in the area of SEF execution where timing differences exist between different jurisdictions. We're seeing two different pools of liquidity develop. One where the clients and entities who are subject to Dodd-Frank are executing on SEFs and are under that regime and another where the entities who are not subject to Dodd-Frank are trying to stay out of it and trading among themselves. Having two liquidity pools cannot be optimal for the market at all. That's another unintended consequence we're starting to see.

BH Picking up my earlier point on the relative attractiveness of particular types of market, looking away from the direct requirements of the market structure, whether it's clearing or reporting, you clearly will have to keep an eye on the broader environment, particularly the capital rules. We've recently seen significant changes to the leverage ratio which doesn't directly affect the requirements under EMIR, but it sets the scene much more broadly. And there's still a lot of work going on on that front, plus the impact of the collateral rules for non-cleared business.

SG Let's think about how you will be operating in, say, six to nine months' time. There is a view that OTC and exchange-traded derivatives will be converged. This will create a world of standard contracts which might be futures, swap futures, constant maturity futures or standardised SEF-traded swaps. Alongside these will be the genuine OTC products. On top of this, there's a view amongst FCMs and technology firms that providing some sort of aggregation of this liquidity will be incredibly important. With 20-odd SEFs emerging, how can you access all of them concurrently? Do you share those views?

RMe We've heard people talking about algorithmic trading and that the reporting requirements will start to break down the trade size. People end up doing more tickets, but overall probably no greater volume.

AP We also wouldn't anticipate a drop-off in volume, but ticket volumes will go up. With respect to SEFs, it's a watching brief at the moment from a liquidity perspective. The pedal is down to the floor on reporting and clearing, those are the immediate regulatory obligations. SEFs and swap futures we are aware of, we understand the implications but it's not something that needs tackling this week! It's all about making sure we hit the balance between meeting obligations whilst also moving into some of the market responses to those obligations at the optimum time, or not.

SG How far have you got with thinking about new products, swap futures or constant maturity futures, for example? And if you did want to trade them, would you have to get approval from your compliance team?

BH It would go through a normal instrument approval process internally, but we haven't started approving those instrument types yet.

RMa And if it's a cost-effective instrument, that process can be quite quick, can't it?

BH Oh yes.

RMa Eurex is obviously looking to clear firms' OTC business and their listed business. We are working on deliverable swap futures and the constant maturity

"It's important that CCPs are able to process these products in a really efficient manner and hopefully we can go some way to alleviating the cost burden that these guys face."
Ricky Maloney, Eurex Clearing

futures that you mentioned because we see it as extremely important that when you're investing or when you're trading a derivative, listed or OTC, it's got to be the most capitally efficient product you can trade. And, as a CCP, we have a duty to deliver optimal efficiency for clients. So, if we can provide cross-product margin, that's something we like to do. Obviously that needs to be done within a secure environment, but it's important that CCPs are able to process these products in a really efficient manner and hopefully we can go some way to alleviating the cost burden that these guys face.

SG Is that practical, given that each SEF will be a member of multiple CCPs?

RMa Well, while I think interoperability is completely out of the window. It is practical if I'm trading European interest rate swaps and I also want to trade Bund, Bobl, Schatz instruments, it makes sense for me to clear that within my margin-efficient account at Eurex. So that's where I refer to the pre-trade decision. Whereas before a trader would put a trade on, and the collateral implications of that would be felt in the back office probably two days later, it's completely changed now. Now, it's a pre-trade decision. Somebody needs to come up with a pre-trade margin analytic tool that encompasses all products within all CCPs within all clearing member accounts. It's incredibly difficult, but it's possible.

BH We are looking at all of these products coming down the track, because we need to do what's in the best interest of our clients. So the most cost-effective strategy is important, but the key is liquidity. It's difficult for buy-side firms, because they're typically price-takers rather than market-makers. I can see a lot of chicken-and-egg scenarios starting, whereby contracts start to trade, but there's no liquidity, and the buy-side say they can't trade them because there's no liquidity. We are watching what's happening in these markets.

SG And are your clients, Hester, asking for sophisticated solutions to this, or are they behind the curve?

HS Clients are trying to deal with the immediate, urgent issues, such as reporting, segregation and mandatory clearing. People have not yet started to focus on optimising their margin or the use of their collateral. They're starting to think about those things, but the first order of business today is really about being compliant for 12 February reporting. Naturally, they have questions like: What do the segregation models mean for me? Do I need to opt into that? Who is going to be my OTC clearing provider? How do I make sure I'm ready and on-boarded by the time mandatory clearing comes through? That is the immediate focus. Later on people will take a step back and look at new products for optimising margin, for optimising collateral use.

SG Is that the view of your members, Richard?

RMe I think so. Generally speaking if you look at the dealer model, it's going to be one of trying to sit in the middle as an intermediary, running a flat book in which ever instrument is being cleared. And in those circumstances, netting – and particularly multilateral netting that you get through a CCP – is going to be very valuable indeed, because the net-down will be huge.

Whether that's true for all buy-side clients is another matter, because you're more likely to have a 'directional' portfolio (from the CCP perspective). Say it is swaps clearing we're talking about, you will either be expressing an outright investment view through the swap or you will be hedging something else (like a bond) that is not subject to clearing. Either way, all the CCP will see is an open swap position, without any other offsetting swap. That's the subtext to all this talk about commercial efficiency. As I understand it, there are people looking at how you can channel a trade to one or other CCP so that it reduces exposures there. How far and how quickly we get to that, we'll have to see. But people are beginning to think about these sorts of things. And, longer term, the ability to net across OTC and traditional listed is going to be an interesting one to explore.

SG If I'm a very large, risk-averse buy-side client that has historically traded bilaterally with other similar sized and equally risk-averse buy-side clients, there is an argument that forcing me to use a CCP is actually increasing rather than decreasing my risk. What are your views on that?

RMa This is where choice of segregation models comes into it. In the OTC space we've had that since November 2012, and it's brilliant. Buy-side asset managers are very risk averse and I understand exactly what you're saying because you would choose the counterparties that you wanted to trade with. If suddenly you didn't like the look of them, you'd stop trading with them, whereas now you'll be potentially pumping your positions into the same CCP. But that's where asset managers or pension funds need to find a trade-off between operational efficiency and asset protection. For me it's always been about asset protection. Operational efficiency is nice, in that sense you might prefer an omnibus protection structure, but in terms of full physical segregation and the ability to port those assets in the event of a default, that for me is where the value sits.

BH There's a much more crucial point here, and I've made this point to somebody at the FCA. Regulators have effectively approved largely theoretical clearing house models. Nobody has proved them to be scalable or that they can continue to work in a real crisis. So, for me right now, to even consider putting clients into one of these segregated models that we know is not scalable would make no sense.

RMe And they are quite recent, these models. They have emerged relatively late in the day.

RMa Well, that's fair, in a sense. Some CCPs have developed new models 'just in time' in response to the new regulation.

SG Ricky, do you think that competition between CCPs is a good thing for the industry? Since that's where all the risk is being concentrated do we really want people cutting corners, taking shortcuts or trying to offer more efficiency with virtual offsets?

RMa You have to do what you can to provide benefit. If you put on a risk-reducing trade at Eurex, for example, you'll be paid the margin back same day. What we've taken away there is the cost of double-funding for clearing members. Those are the kind of cost-saving benefits that we've tried to add without increasing the risk profile of the business in any way, shape or form.

So if we look at Swiss francs, for example, and if you go out 20 or 30 years, we are probably the most expensive CCP to clear that currency at. That's because we have a liquidity adjustment factor at the top end which we think is appropriate. Now, does that mean that we should reduce our level to fit with the market price point, or do we stick to our guns and do what we think is right and assume that the other guys are undervaluing?

SG In terms of the sell-side – the FCMs and the brokers – how well are they helping you navigate this new landscape?

AP Well given the audience, I clearly can't say anything other than they're helping us tremendously and doing everything we could wish. As I say, the transaction chain has got a lot bigger and necessitates us talking to multiple clearing brokers and multiple clearing houses all with slightly different offerings. Trying to assimilate all of that information and get a clear picture of what the landscape looks like, how you interface with it, and what it will look like in six or 12 months' time. At the same time, you're communicating to all the different client types and trying to paint a picture of what that landscape looks like specifically for them. It can be diverse and challenging but that's the business we are in.

RMa We have tremendous support from both the sell-side and buy-side. We have separate committees that meet with both elements, because it's important that what we deliver as a CCP is appropriate.

BH It's been one big team effort with everybody working together. Even where we're working with clearing members who are not on our panel of clearing brokers they've been more than willing to help. And that trading of ideas is what's really driven a lot of the developments.

SG Hester, looking at the big sell-side firms, they've traditionally had separate FCM and OTC execution businesses. As those two worlds converge, there seems to be some tension arising as to who owns all of this. Do you see any of that at all?

HS The OTC trading desks are still quite separate. But certainly the clearing businesses are coming very closely together, and are already very much aligned. I report to the same management as my counterpart in futures clearing. They will likely get even closer over time because clients want to have a single point of contact.

Right now, it makes sense to have them separate because of the details of what's going on in the OTC market, but once mandatory clearing is fully established, you'll want it to be more integrated with your futures coverage and maybe have some people who focus on new asset classes. We're definitely preparing for that. Our teams already sit alongside each other and are starting to cross-train. On the clearing side, we really see it as a single product.

On the execution side it will probably remain separate. There are also legal requirements to have certain Chinese walls, to have some of those duties segregated.

SG We heard earlier from some other vendors about how hard they are finding it to keep up with the level of change. And Bill Templer was saying how the FCM model is currently struggling to make a good enough return in this environment. So, when your brokers come round and say I'm really glad you appreciate all my help, but you're going to have to pay me more money, what reaction are they going to get?

BH There are a number of changes going on. The main driver is capital and the Basel III regulations make a lot of changes to the capital requirements. As end users, we need to understand that the service offered is priced on a cost-plus basis, and if the costs of providing it changes, then we have to accept that. The other thing is that the buy-side have pushed quite a bit for segregation. And that doesn't just apply to OTC, it also applies to exchange-traded derivatives. That is another key driver for change in the pricing model, potentially, because the excess margin that the broker could hold on to previously will be at the clearing house.

RMa There's also the prospect of charges, not from Eurex but from alternative CCPs, for segregated accounts. Well, it's not a prospect, it's a fact.

HS And it's operationally more difficult to manage, potentially, when you need to move the assets around, and so there's justification for it.

SG Do you think IMA members would be receptive to increases, Richard?

RMe We have to be careful here because we can't start straying into something which could be characterised as anticompetitive in any way. So what

"The transaction chain has got a lot bigger and necessitates us talking to multiple clearing brokers and multiple clearing houses, all with slightly different offerings."
Adam Pacey, M&G Investments

it boils down to is that it is for individual firms to undertake commercial negotiation, subject to basic ground rules and understanding. Longer term, if there's some sort of industry-wide consequence, I suppose we would be able to look at it, but most of our focus has been on things like getting Eurex and the other CCPs to describe their offerings and how those have evolved. We've done that in the recent past and found it helpful for members. But that's probably about as far as we can go along with organising discussion groups on how to populate reporting, required fields etc which is work that continues.

AP Nobody expects anybody to be running at a loss on this, but it starts to pose interesting conundrums for buy-side firms. It's best practice is to have multiple clearing brokers, we all know that, but with the best will in the world those clearing brokers' and clearing house prices and risk profiles aren't going to be aligned. Then you face the question how do we split our cleared business between those brokers/CCPs whilst also making sure you minimise the spread of collateral pools and maximise margin offset. I suspect there are many different approaches and there is probably no right answer, but it needs working through.

RMa I think the pricing point will find its level, though.

AP Yes.

HS I think there's enough competition around that it will end up in a fair place.

RMa We've always been aware that it's currently priced with an unknown cost element, subject to significant change, should it be required.

SG Richard, you had a few numbers you wanted to share in terms of what's actually happening.

RMe I was curious about what had happened to OTC volumes. They've continued to rise generally but at a significantly slower rate, based on the BIS triennial survey updated in April 2013 with figures released at the end of last year. You see a plateauing of daily average volume, which has been arguably happening for quite a while. It's not really grown that much from 2007 onwards. The growth has been going down and down. And, if you look at the market for swaps in the US, daily volumes went down from about 641 billion (notional) to about 628 between 2010 and 2013. I don't know if that is people anticipating the regulatory effect, or whether it's some broader effect, but it's interesting that the huge growth that you saw in previous triennial periods with growth of over 100 per cent in some cases, has just tailed off.

SG Is that what you feel has been happening, or are you surprised at those numbers?

AP Not surprised. I think it is anticipation of the regulation. We'll certainly continue to ask if OTC is the best product, given we know that we've got a broadly clear yet slightly opaque environment in front of us, particularly on things like costs and efficient collateral management.

SG Has anyone in the audience got a question to pose or a point to make?

Lee McCormack, Nomura I've got a statement and then a question. There are different business models being adopted by the sell-side, with some seeing it as a pure silo business and looking at the return on capital. Others are bundling it alongside other services. So there will be a lot of competition, still, on pricing. While pricing structures may standardise, I think actual pricing will remain competitive for a while. That's also subject to there being enough business to go around. So if all the buy-side choose the same three or four clearing brokers, then competition will disappear. So, be careful what you wish for there.

The question is this. Futures and OTC are converging but, I think, only at the top level and in terms of position-keeping, accounts, platform technology etc, it's not quite there yet. Do you think this will happen, and if so, when?

RMa Will it happen? Yes, in some respects. How will it happen? In developing the OTC clearing infrastructure you started from scratch, whereas with ETD you're working with an existing infrastructure that you've got to shoehorn into that. I think the businesses will converge. Clearing members for some time have been moving towards that. Products are also converging. You'll always have your remaining bilateral industry. That will carry on. Then we come back to new products like deliverable swap futures and constant maturity futures, etc. So, yes, they will converge, but not entirely.

BH The markets have always coexisted and undoubtedly they are coming closer together every day. People keep trying to dream up new products that get things out of OTC and into the listed space. That should help both sides. The sell-side from a capital perspective, I suspect, and the buy-side from a cost and margin perspective. There will be an increasing coming together between the two.

RMe It used to be said that the two were complementary, that the listed and the OTC fed off each other, to some extent. If you reduce the differences between them, what happens to that symbiosis?

SG That's a good question. What you're trying to do from a technology perspective is to offer someone the optimum contract. This may involve looking at the clearing efficiencies spread across a range of similar contracts that have different margin requirements at different clearing houses. And each clearing house may operate its own type of margin offset.

So, what you're trying to do in terms of the front end screen you provide is to reach right into the back office plumbing and see what's going on there and then somehow reflect that in a front end trading screen. You're almost reversing the whole workflow of the business model that has existed up to now. The real question, then, is whilst technically it can be done, is the cost of doing it enough of an advantage for a particular FCM to justify the cost?

One or two of the larger broker dealers have made a lot of noise about having thought all this stuff through. I know there are other firms thinking about how they do this as well. But do they see this as something they collaborate on or are there firms that want to go out on their own and build this capability? And will the cost of doing it outweigh the benefit in terms of the clearing efficiency for market participants?

RMa Collaboration is very important but in the banking industry that's often anathema. I think the future is all about aggregation, about small, smart, agile firms that can aggregate tremendous amounts of data from multiple sources.

SG Are there any other questions or thoughts from the audience?

Piers Evans, Markit There was talk earlier of segregated liquidity pools for those who have to trade on SEFs and people who don't. Does the panel think, when European legislation becomes clearer, that those pools will re-converge, or do we think that there will be continued regulatory arbitrage with people just moving over to Asia? We've certainly seen, for example in the data that we presented recently to regulators, that there was a move in the non-US currencies away from trading with US counterparties, for example, round about the time that some of the regulations here were coming in? Is this temporary or will it all re-converge?

AP On the first point, about moving away from US counterparties, there was such a lack of clarity around how you got caught up in Dodd-Frank, the definition of US persons, etc. I'm not surprised that happened as the events and application of the rules unfolded. Some will have taken the view that they could take the issue off the table by focusing on their European or Asian business relationship.

This isn't really a question about arbitrage though – equivalence and substituted compliance mean it's more a question of where and on whose timetable you get compliant, not whether you do or don't comply at all.

"The markets have always coexisted and undoubtedly they are coming closer together every day."
Barry Hadingham, Aviva Investors

Unknown male How big a problem will the lack of available collateral be for the buy-side in the near future, especially with CRD IV and Basel III, and limited balance sheet availability for repos?

AP It's something we've looked at a lot. Initially I think the market focused on the big funds with lots of derivative positions as being those who would most likely have issues in terms of available and eligible collateral. In fact it's more likely to be the more niche funds that were very low users of derivatives but that have very specific investment mandates that may run into issues. There is also a degree of added complexity with other regulation impacting some of the tools you may use to solve those issues through repo or re-hypothecation. So it definitely presents a problem, a very big problem for the firms that have got it, but it's unlikely to be big in terms of quantum.

BH There are a couple of things I would add. Aviva is very active in the securities lending market. So we actually put a lot of collateral back into the system. The real question is, will firms like Aviva still be able to do that going forward? In future will we have sufficient surplus collateral to be doing that? I don't know the answer but it has knock-on impacts across the chain.

AP Not least in terms of costs. We discussed cost in terms of clearing broker and clearing house charges, but of course there is the potential for opportunity cost in terms of lost securities lending revenue as a result of assets being tied up as collateral.

SG It's ironic that the pressure on collateral may mean that people reduce their use of derivatives which, in their purest form, are a great way of hedging risk. Instead, they may simply say they'll just wear the risk rather than pay the insurance premium. How that then reduces global systemic risk, I don't know.

BH There's another argument, Steve, in that essentially that makes collateral a whole new asset class. So, where's the best bang for my buck? Am I better off giving my collateral to someone else to use, and stop trading the derivatives, and get the return that way, or do I carry on using them?

RMe You can make the case that a theme running through a lot of the regulation has been trying to damp down liquidity. We all talk about liquidity as though bigger volumes necessarily mean more trades, but we've already heard that you can split one big trade up into a lot of small ones. Is that more liquid or not? But if you take a recent example, the European Commission proposals on bank structural reform include elements targeting re-hypothecation. You've got the Financial Stability Board still looking at that and chains of collateral are something that there is a regulatory bias against. We've got a way to go on what the final impact of that is.

SG To conclude, I'd just like to ask each of you how different you think your lives will be in the next 18 to 24 months and why?

RMe It's very hard to predict but clearly the landscape is changing. There is still one big issue that's coming into focus, which is CCP recovery and resolution. We've talked a lot about bank recovery and resolution. That's a big issue but we've still got the CCP recovery and resolution to sort.

HS It is very hard to predict what will happen. On the positive side, there will be a new group of clients who don't do OTC derivatives today, (because they're not allowed to by their charter because there's no clearing and no end-of-day mark to market), who now all of a sudden will have access to that product and will be able to start using it. So the good news is that there may be new users entering the platform, which we will see probably two to three years out.

AP I think collateral is the new asset class. It's taken it from post-trade burden to pre-trade prerequisite. There's an ever-growing level of sophistication at our clients about how they can best direct their asset managers to manage their collateral in an efficient way. As a result of those two things coming together, there's collateral management mandates to be won, if you're an asset manager – particularly if you work with either a vendor or a bank doing some of the work you talked about earlier in terms of being able to provide the tools allowing you to manage it in an optimised fashion.

RMa I agree with that, collateral as an asset class. There's a tremendous opportunity for asset managers, pension funds etc that have got high-quality assets to lend out.

BH My personal opinion is that the market will continue to evolve. We'll find a way to broadly do what we do today, however that's implemented. I think there'll be a combination of probably more listed product and maybe a bit less OTC. The operational challenges – collateral management and so on – will be significant but I think broadly we'll be doing what we do today.

From left to right: Andy Ross, Jerome Kemp, Walt Lukken, Anthony Belchambers, Bill Templer

Panel session 3:
Derivatives market infrastructure and the FCM business – time for reassessment?

Moderator **Bill Templer,** Faventus Consulting

Panellists **Anthony Belchambers,** FOA
Jerome Kemp, Citi
Walt Lukken, FIA
Andy Ross, Morgan Stanley

Bill Templer Our panel has a vast knowledge of the changes of the past few years and has first-hand experience from both an infrastructure and risk point of view. I've asked Walt and Anthony to set the scene in terms of some of their experiences, particularly with regulators, as part of their responsibilities over the past year.

Walt Lukken I was asked to set the scene tonight with a description of where we stand in the FCM community and the industry. So I wanted to talk about some trends that we're seeing in our industry. Rather than looking at what has happened since the financial crisis or since Dodd-Frank, I took a longer view and went back ten years to look at some of the numbers published by the Commodity Futures Trading Commission on futures commission merchants in the US. Obviously those numbers can only tell us what is happening to the clearing firm community in the US, but I think there's a lot of commonality to the trends you're seeing here in Europe

If you look at the FCM community, it's shrinking. Ten years ago in the US, we had about 177 FCMs. We're down to under 100 today and, with the regulatory burdens, new capital requirements and costs that are coming into place, we're probably going to see continued consolidation. Certainly there are barriers to entry now to enter this business and become a FCM. You need a big balance sheet and the legal and compliance requirements are much larger than they used to be. There are only a limited number of participants that have the resources to be FCMs, and it's getting more limited by the day.

I also looked at customer funds held by FCMs in the US. The good news is that customer funds have grown enormously over the last ten years. In 2003 we had about $62 billion worth of customer funds. We're up to about $142 billion in customer funds as of September 2013. On the other hand, we shouldn't get too excited because we were at $169 billion prior to MF Global and the Lehman crisis. We don't seem to be adding much to the customer segregation pool and it's worrying that those numbers aren't growing as much as we'd like.

Another headwind facing the FCM community has been interest rates. With interest rates it's a double effect. Firstly, interest rate futures has been an absolutely central part of this industry for a long time, but the credit crisis took away a lot of the demand for these products and they're been much less active over the last few years. Secondly, for FCMs this is where they traditionally have garnered revenues in the past. So if interest rates start to rise, that is a very positive trend for us.

Looking at the exchange community, it's a similar story. Ten years ago, there were 18 registered exchanges in the United States. Many of those – NYMEX, Chicago Board of Trade, Kansas City Board of Trade, the CME etc. – have consolidated over time. We are down to eight registered exchanges now in the US and that reflects what's going on internationally.

Clearly we have grown volume enormously over the last ten years. In 2003 we had about $7.2 billion of contracts by value traded globally. We're at about $21 billion today. The FIA tracks volume for the year and we got 2013 US figures yesterday. It is up about 9 per cent according to our figures. We don't have all the international figures yet but it should be about on par with last year. We're not going to see a decrease. So we're seeing a greater amount of volume being pumped through fewer and fewer exchanges.

I would say that we are at an inflection point. When you're in the middle of a trend it's hard to tell what trends are happening but I wanted to point out a few issues you might look out for over the next year which might indicate what direction our industry may go in.

With respect to the cost of clearing it's easy to want the best and safest system until you find out what the cost of that might be. Once the costs of clearing start to be realised by the marketplace and are being passed on to the buy-side community, then we'll start getting into the nuts and bolts of how this system will work because there will have to be tough decisions and trade-offs. That's something we should be looking out for this year.

This may be the year that clearing efficiency finally comes of age. I worked at a clearing house before this that built itself based on portfolio margining and trying to find clearing efficiencies. That is great but we did that two years ago when people were busy with Dodd-Frank and myriad other things.

This might be the year when people start to care because they're not garnering profits in other places. They'll have to look for other ways to cut costs because there are headwinds that are pulling us apart and fragmenting the markets.

I'd also like to talk about regulatory pragmatism. It doesn't cost that much for the CFTC to write rules, even if they're regulating the world. The real cost will be incurred this year when they start to police those rules and look to enforce them with swap dealers

"With the regulatory burdens, new capital requirements and costs that are coming into place, we're probably going to see continued consolidation."
Walt Lukken, FIA

and exchanges around the world. Just like clearing members, the CFTC leadership will have to make tough decisions based on what money and resources they have. That will drive them to talk to other regulators about substituted compliance, mutual recognition, and all the things that we've been talking about as an industry for a while.

And lastly, the wild card is interest rates. In December, when the Fed signalled that they would begin to taper and pull back on the asset purchase program, the market reacted favourably, but the job numbers are bouncing around, so it's a little difficult to figure out where the Fed will go with regards to interest rates long-term. It will have a big impact on our industry should interest rates start to tick up.

Anthony Belchambers To add to that, economic recovery will obviously bring opportunities but we need to be careful to understand that the delivery of a super-safe systemic and market system, enhanced customer protections and all those other things that people want to see post-crisis, come with a real cost burden attached.

We are also in a world of customer confusion. Customers will need many more value added services to make sense of what is a massively changing marketplace and that's one of the things where organisations on the sell-side can add real value.

I would also say that we're in a world of colliding public policy objectives. You hear governments talk about wanting growth and business recovery but the regulators are compressing the ingredients required to do that. They want to contain risk, they want to contain innovation. Those regulatory targets don't sit easily with the post-crisis growth agenda.

Another thing is risk management. One of the lessons of the financial crisis was how important risk management is. It's essential. And yet here we are pushing up the cost of risk management across the board and curbing order flow that takes the opposite side of a risk management trade, and if the FTT thing comes in, there's no exemption for risk management so we're going to be taxing risk management trades. Another example of colliding public policy objectives.

Everyone says how important market liquidity is. I know some believe that order flow is too high, etc. and there are some politicians who would like to see less of that. But the fact is, if we believe in market liquidity, in free markets and in legitimate order flow, why are we going down this route of compressing speculation, high frequency trading, short selling and bank proprietary trading?

And by the time you've ramped up the pass-through costs on customers you will also see less order flow from them! Smaller markets will find it difficult to be viable and yet they're very important for those who need them to deliver specialist risk management products.

To touch on the regulation of cross-border business, we are in a global marketplace but the regulation of cross-border business is an absolute mess. You just have to look at clearing, execution and market access. Regulatory conflict and complexity of compliance will increase customer confusion, cost and legal risk and indeed the risk of inadvertent breaches of rules. IOSCO has a new Task Force to try and do something about this and I really hope they are successful.

Back in the early 1990s the CFTC were thought-leaders in this space with their Part 30 rules. But there has been a significant shift in policy and you have to ask why? There was nothing wrong with the Part 30 rules in the 15 to 18 years they were used, so why the growing regulatory protectionism?

My next point is on collateral. Some say there is going to be a collateral crunch. Others disagree. The fact is that one of the big added value services is going to be collateral optimisation, management and transformation. However, collateral transformation will not come cheap, depending on supply and demand, how much high-quality, highly liquid collateral there is out there and how you define it.

Moving on to customer confusion, customers will want more services, more market information and even more advice because they want to know how to handle their business. They will want more transparency. They will want to know how and from where to get best execution. That's where added value services will be needed.

Clearing costs have increased and we've heard how numbers of clearing members are diminishing for all sorts of reasons. Clearing profitability has changed fundamentally as costs increase, risk goes up and revenues go down. Some of the more specialist clearing firms may simply pull out because they won't get the return on capital required. There may also be problems for very small, low-volume market users to get access to the markets because clearing could become very expensive for them because they're not high-volume users.

We'll have to see under MiFID how the trading obligation works out. What is the criteria? What products will not be caught? A lot of questions remain regarding the trading obligation. And is there a difference between execution on a multilateral trading platform and executing under the rules of an exchange? A dialogue yet to begin.

Another point is that it is likely that firms will have to focus on core businesses, core geographies and core customers to help them come through this wave of regulatory change. That means there will be a few crumbs for smaller firms to pick up new business in more specialised areas. So there will be opportunities in all this as well.

Lastly, we're in a world where the regulators are now shaping the marketplace. Before the crisis, markets were designed to fulfil the needs of customers and regulators had to do the work around. Right now it's the other way around. The regulators are shaping the marketplace and it's the customers who will have to do the work around. There will be a price to be paid for this. Personally, I think it's completely the wrong way around but that's where we are right now and that's what we have to deal with.

BT I'd like to start with a point that both Walt and Anthony made about the shrinkage of the FCM community. Do you see more shrinkage? Is it a good

"Regulatory conflict and complexity of compliance will increase customer confusion, cost and legal risk and indeed the risk of inadvertent breaches of rules."
Anthony Belchambers, FOA

thing or a bad thing? I once felt there were probably too many FCMs for the amount of business and the quality level wasn't as good as it might have been across the board, but what do you think, Jerome?

Jerome Kemp Walt made a very good point that we're seeing order flows consolidated in an increasingly limited number of hands. Concentration risk has become a key issue and one that we're spending a lot of time grappling with. One of the major investments that this industry has made over the past five years or so has been in the risk management space. That has been motivated either by the evolving regulatory landscape or by the realisation of shortfalls that existed in risk management relative to the business that we run.

On the flip side of that is concentration of business at the CCP level. For me this is more of a concern because you really do have less than a handful of CCPs who are channelling an absolutely phenomenal amount of risk. Many of these CCPs also are publicly listed companies and have shareholders to pay. There is a major disconnect between the regulatory objectives of creating safer marketplaces and the concerns of companies who seek to satisfy certain hurdles relative to the returns they provide to their investors.

A particular concern with regard to the CCPs is the increasing leverage they have relative to monopolistic pricing power. Recently we've seen one very large CCP introduce market data fees and an overall increase in fees by way of dictating to the industry at large without any real consultation whatsoever. We were all taken aback by the abrupt nature of the announcement, particularly given the increases in transaction costs we're seeing in a much more tightly regulated marketplace. These are real concerns.

Whether there are solutions to the concerns on concentration is up for discussion. Quite clearly, the hurdles have been raised with respect to the amount of capital required by an FCM to conduct business.

The goalposts have changed in a major way both from a market regulation and a capital regulation point of view and that has forced players out of the market. This is only the tip of the iceberg at this stage. 2014 will be the year of the realisation of the capital bite for FCMs and I can only guess at what the FCM community will look like at the end of the year in terms of absolute numbers.

Andy Ross One area of focus for us has been making the market safer by putting OTC products through a clearing house, and I think the industry has been successful in doing this. However, if we look across other products, such as UK inflation swaps, the number of investors trading is relatively small, making the market highly concentrated and more risky for clearing houses.

From our conversations with clients, we see they are keen for inflation swaps to be cleared for a number of reasons, including de-risking. In the past, the amount of concentrated risk you had to hold was more easily answered than it is today. From my perspective, the question is not one of "can I clear inflation" but rather "will I be mandated to clear all inflation products and do I have control around my concentration risk premium on them?" This corresponds with Jerome's point.

Another focus area for us as an FCM is around segregation. EMIR Article 39 says that we must make available to clients a choice of segregation offerings, however, while most CCPs have a segregation offering, they are very different from one another, creating significant challenges when trying build a one size fits all offering for clients.

For example, If I have a small number of clients who are interested in clearing in a less mainstream market, I still have to offer those clients the opportunity of individual segregation. That means I need to have a process in place and I have to understand that market. So the question is, is it economically practical for me to stay and clear in this market and provide the service for a very small number of clients?

There is a strong case to suggest, with increased pressures on the industry, we will see either a drop in the number FCMs or in the areas they clear, as evidenced by companies already pulling out of certain markets. For clients, this also drives the question around availability of liquidity.

BT That comes back to the broader question of why would anybody want to be an FCM at the moment? Can we create a different model to the way it operates now?

JK I would argue that the concept of the FCM we have had over a couple of decades is rapidly and fundamentally changing as the regulatory and capital environments evolve.

The fundamental change is that the decisions we take as FCMs have an incredible importance and strategic implications for investment banks. These things are part of a much broader agenda and the winners will be those that really can break down the silos and reach across a broad range of assets to offer to clients both in terms of clearing, which is one of the keystones of this new world order, and execution.

AR I agree. When looking at SEFs, clearing is regarded as a mechanism used to help keep the process clean and where the clearing provider is fully engaged in executing trades and providing a guarantee.

The changes occurring across the process are having a knock-on effect with risk management. Under the new rules, FCMs are clearing products extremely quickly via hubs or directly to SEFs, providing access to limits and guarantees at the time of the trade. In essence the FCM is 'pre-clearing', which results in a very different risk position. This creates a new question around the broader Firm strategy. As an FCM, the challenge is to create a balance between ensuring we make a return on capital while providing clients with a first-class service.

BT Doesn't that just bring us back to the age-old argument that the price is wrong? Surely this is as simple as getting to the right price and making a profit and a return.

AR A number of firms are leaving the market, as evidenced by Walt's statistics. Less established FCMs are realising that making a return in this business is challenging. This consolidation is likely to continue, and while it allows the remaining FCMs to do more

"The fundamental change is that the decisions we take as FCMs have an incredible importance and strategic implications for investment banks."
Jerome Kemp, Citi

business, costs are continuing to rise.

FCMs' returns are traditionally achieved through execution revenue, clearing revenue and interest revenue. With rates at almost zero, interest revenues are contributing less and therefore a more normal interest rate environment will be beneficial to the industry, not only on volumes but on spread-based returns as well.

JK There is perception on the part of clients that what happens in OTC clearing from a pricing perspective will more or less mirror what has happened on the futures side. The key differentiating factor is that for the first time there are major extraneous factors driving the pricing agenda.

FCMs don't control the cost of Basel III nor the enhanced risk controls or segregation models; that is something passed down by our regulators and there are costs associated with this. So while we are very keen on capturing as much flow as possible and providing clients with the most efficient services on the execution and the clearing side, we are also conscious of the fact that the amount of capital that's needed to support this business has increased phenomenally in the past few years and is expected to increase even further moving forward. FCMs will have to readjust their pricing models to reflect this re-evaluated baseline cost.

AB What you're saying is customers will have to face increased regulatory costs that you will have to pass on when offering your services? Will you identify these by some form of surcharge that demonstrates it is a regulatory charge – not a business charge?

JK Transparency is a very important factor here. Referring back to the confusion around pricing, some clients don't fully understand what FCMs are doing and the key developments impacting the FCM space. It's our responsibility to be thought leaders and drive the education agenda. There has to be a growing realisation that we have to provide a certain return on capital above and beyond all of these passed through costs.

BT Some buy-side firms understand some of costs are not under your control and therefore they should be passed through. People would probably have a reasonable discussion about that. But that doesn't necessarily increase your margin or profitability or to achieve the required return on capital. For that to be achieved FCMs will need to look at change, improvement in service and differentiation which is seemingly becoming increasingly difficult.

How can FCMs come up with something a bit different? Considering that FCMs don't have a great deal of IT spend at the moment for macro reasons but also because 90 per cent is going on regulation and mandatory change, what can the FCMs do to create that extra value now?

AR Consistency of the clearing process, whether in transaction reporting, limiting the number of repositories, utilisation of limit hubs or on segregation offerings, is extremely important in ensuring an FCM is as strong as it can be.

It is also important for businesses to understand their core offering, and work to their strengths, which might mean some non-core clients miss out. Getting 50 per cent of the way there with 100 per cent of your clients isn't really going to cut it and businesses need to be more focused.

JK An important theme is the development of strategies around big data management and about consolidation of resources within the firm. The ways you can leverage data and manage it effectively is a major element. In the past, many firms had data silos built around virtually every business and those walls need to come down.

There is innovation with respect to providing the ability to net margin, in line with regulatory requirements. This allows us to provide those benefits to our clients because that provides capital efficiency.

BT But will people pay for that?

JK I think the key focus is to get clients to realise the benefit of these types of mechanisms as they aren't broadly understood at this stage. We are, for instance, offering our clients the ability to offset OTC cleared swaps against their futures on the CME. It's these types of innovations that have been introduced by CCPs that we've been able to start to leverage for our clients as they provide efficiencies. This will gather steam as we move through 2014 because this capital bite will loom up in front of clients in a way that perhaps many aren't expecting it to.

BT One of the observations from this is that this is a two-way thing. You can try and increase charges to clients but it's incredibly difficult. There is still competition around and clients don't want to pay more. But the other side of it is reducing costs and our industry has possibly stagnated operationally over the last ten years, in terms of how to process things, but also particularly when it comes to the delivery of new releases from exchanges. Too often these are not standardised and consistent, so every time there is a release, every vendor has to change something, which then has to be tested by an FCM. Can the FIA and FOA do more to get a bit more consistency and standardisation?

AB We have done some of this already and I know the FIA has as well. The difficulty is that exchanges have their own perceptions about how they want to do things, about competitive advantage and different types of models.

We're also doing a lot in the world of standardisation, netting opinions, documentation and risk disclosure documents. We have to go much further down that route because it makes economic sense for the provider, but it also makes a lot of sense to the consumer who will not need to get legal advice on every single document and work out the differences.

WL Trade associations by definition are collective agencies for their membership, so FIA has for several years had an FIA Tech subsidiary, which has served as a utility for certain functions in the industry.

If it's more expensive for member firms to do something individually than for the mutualised trade association to do it for them at a cheaper, more cost-effective way, we're there as a service provider to provide that.

We're also looking at other functions in the risk area that may benefit members in a non-competitive way because we want the marketplace to be competing on services and innovation. Or we can help facilitate problem solving as a trade association. So, for example, FIA led the industry efforts to implement LSOC, the standard used for segregating collateral for cleared swaps in the United States.

We involved all aspects of the infrastructure of the marketplace in this project, including the exchanges and clearing houses and the buy-side community so that we could come up with a standard for the industry with everybody on the same page. And it really benefits people because they don't have to deal with multiple ways of doing things. It makes it much more cost effective for the industry.

BT Isn't that scratching the surface a bit? Part of the problem is the industry shot itself in the foot regarding standardisation when it sold the exchanges. When the members owned them, exchanges could act like a utility and drive standards to the members but that's no longer the case anymore. Do you think member-owned exchanges are something that could happen again to bring things back to the way they were?

WL It's very difficult in a publicly listed environment. There are some hybrids that started to develop and this is a strategy that Duncan Niederauer at the New York Stock Exchange was pursuing prior to ICE taking them over. Not re-mutualising exchanges but trying to find strategic partners to own aspects of the exchange.

Investment banks are big in this where they have strategic investments in certain infrastructure and they want to be part of the decision making and that may include buy-side people as well that are utilising the markets. So in some ways you can get the benefits of re-mutualising through the ownership structure. The track record is a bit mixed, but certainly there are people who are thinking about trying to get at that mutualisation idea through the equity ownership aspect of the exchanges.

AB We are in a world now where everyone is re-appraising what they mean by shareholder value and shareholder return and getting a better balance on stakeholder and customer needs. Interestingly, the FCA is probably the only regulator in the world that now has a competition agenda.

This, if exercised properly, could have a real impact in terms of balancing shareholder return with customer value and preventing more monopolistic behaviours as organisations converge and grow bigger you now have a regulator with whom you can raise a competition complaint. This is an interesting new dimension to the regulatory function.

AR There are positives to be taken from the figures Walt provided on the number of exchanges that exist today. For example, if a trade repository is competing for business in a market with standardised structure, it will have to work within that standard. As I mentioned previously, I do believe we will see consolidation over the next two or three years, which will be a key factor in driving standardisation.

We will see more takeovers. Consolidation will continue over the next two or three years and will be one of the key factors in driving standardisation.

"I don't see smaller firms playing a significant part in the new market structure because the costs and competition are significant."
Andy Ross, Morgan Stanley

BT I'd like to come back to a point you made about smaller clients. In both the banks I have worked for you tended to focus on the top 200 to 250 clients, and that's probably consistent across most organisations. That's likely to be driven even harder now given the return on capital required. Does that create opportunities for other firms to deal with smaller clients, maybe at a higher, more economical price? What happens to those clients? Will they be left in a situation where nobody actually wants them because the return on capital isn't viable?

AR Before segregation, most people opted for low risk firms with a large balance sheet and strong capital position.

The move towards individually segregated accounts in Europe does insulate clients from the majority of risk associated with their clearer, however, elements do remain.

An FCM's rating and balance sheet aren't necessarily as big a contributing factor as before, and I'm sure some investors, when looking to gain access to specialist markets, will choose a more specialist firm. Nevertheless, I don't see smaller firms playing a significant part in the new market structure because the costs and competition are significant.

JK The size of the capital base still is a major consideration. There is a clear capital cost associated with guarantee fund contributions for instance. Any firm will be limited by its capital base relative to the amount of business it can accommodate based on its ability to reserve capital against guarantee fund contributions.

Perhaps this does create an opportunity for niche players on smaller markets where the overall open interest and everything else is going to be pretty much contained. For large global firms that need to clear a trade for a client on a second tier market, that implies a whole host of costs before they are even able to accept a trade for clearing. They have to build their models, make their guarantee fund contribution, go through various jurisdictional reviews to ensure that there is equivalence and that there are netting capabilities etc.

Are these things they want to do? That's a question that didn't come up frequently in the past. Back then, participants were happy be members of 95 CCPs around the world and to clear any type of asset at any time. That debate has shifted significantly.

AB The hurdle for market access to those kinds of customers is not so much execution as clearing cost; that's the problem.

BT Don't the capital costs and so on drive these second tier companies to self-clearing because that seems to be a cheaper option?

JK It's a cheaper option which carries significantly higher regulatory exposure. One of the reasons why clients interact with FCMs is that they are essentially transferring that regulatory burden to the FCM.

BT That used to be the case but now they've still got to do all the trade reporting. I'm not sure that's quite the same anymore.

AB But self-clearing will still take a capital hit because of their exposure.

BT Currently the guarantee funds aren't that enormous. In the coming year they'll have to take a hit against those.

AR The question is not about capital or the guarantee fund, rather it's about whether they have the ability to manage their top tier liquidity and not having to close out positions by not meeting a margin call with a CCP.

Question from the audience As an asset manager running an agency-based business, the capital that I have to put up for my business is dependent on the risk that I run. So as soon as I start to move into clearing transactions for clients, I change my business model; I'm moving from an agency business into one that's more risky. So, for most clients the move to self-clearing is really a non-starter.

BT It might be perceived as more risk but in terms of the capital requirements it's not actually laid out like that.

Question from the audience It fundamentally changes the agency business that you run to one that's much more proprietary which increases the capital requirements quite significantly.

Question from the audience We're seeing take up from retail banks and from local banking institutions. Some firms are electing to self-clear if they have the appropriate model. It's not investment managers as such; it is local retail banks that are doing it.

BT Or treasury managers or people like that.

Question from the audience Yes, also pension funds maybe. If they've got a desk, they've got the capability.

Question from the audience To pick up on one thing Jerome said about the concentration into fewer CCPs and the fact that they're in public ownership, is there a better ownership model and what would you recommend?

JK It's hard to talk in absolutes. Is there a better or worse model that we can imagine? The latitude that publicly owned CCPs have enjoyed is something that needs to be scrutinised more closely in terms of risk management policies in particular.

WL This is something that we've thought about at FIA quite a bit. It's difficult to put a new ownership structure on these clearing houses but there are ways to make the clearing houses have skin in the game to ensure that the risk doesn't just fall on the shoulders of the FCM community alone and ensure that shareholders bear some of that risk. They certainly share in the upside of the clearing houses doing things right so they should bear some of the downside.

The white paper recently issued by The Clearing House suggests about 25 per cent equity in the waterfall somewhere. So that's something. With more and more risk going to fewer and fewer clearing houses that's when organisations like the FOA and FIA start to take more interest in making sure that we understand the waterfalls, that there is some consistence across clearing house, that there's skin in the game, all those important points to ensure they will be doing their jobs and managing risk better in the future.

BT I probably felt like Jerome about this when I was working at an FCM. Having spent a year or so now on the board of Eurex Clearing, I've been incredibly impressed that there is a complete risk management focus. It's not about competing, that just isn't a consideration at all. So I'm not sure it's as prevalent as we think. The regulators are preventing that as much as anyone else.

JK We had a very good illustration of this when we first had a look at the SEF rules which included the obligation to confirm trades as clearable. There was always a risk that a trade would fail at the CCP. We then found out in September that the FCM would essentially carry the full exposure and risk.

The FCM community and the FIA did a very good job to get the regulators to focus on this. The FCM shouldn't be sole owner of that exposure and risk in the SEF model, particularly considering that this is a participant-based model that is dependent on middleware and on a CCP's risk models working, with the FCMs essentially relying on the outputs we received. That's just another expression of how the overall structure of CCPs relative to the risk that is generated in this space could eventually evolve.

"There is certainly an issue with people fatigue. We're dealing with a needlessly complex regulatory and market change agenda."
Anthony Belchambers, FOA

BT But CCPs do have more skin in the game than they ever did. The waterfalls are now much of a muchness.

AB I agree. There's no way that any CCP is going to dumb down on margin calls. The momentum is for higher margin calls, called more frequently. Where there might be an issue is with collateral where CCPs might want to enlarge, to the extent they're allowed, the kind of assets that they take as collateral. That's an area for CCP competition as are offsets because everyone will be hunting for offsets in a world of higher margins. This could disadvantage non-portfolio clearing houses which can't offer offsets.

AR But the regulators are focused on that.

BT They are, but LCH has, for example, just recently said that they will accept gold. Within the constraints set by a regulator, they'll want to push that envelope out a bit.

Question from the audience Picking up on Walt's point, the changes to the waterfall are helpful but if we come down to relying on shareholders bailing out the CCP then we are really back into the taxpayer bailing out the CCP because the shareholder capital is pretty low in comparison with the kind of margin that we've got in the system.

JK That's part of the problem Basel III is trying to tackle to ensure that the capital reserve is enough to cover any tail event that we could possibly imagine.

AR The supervisor of the CCP infrastructure at the Bank of England refers to CCPs as being container ships. His view is that in a storm you still want your container ship to get to the shore. So, the idea of a CCP blowing up and then being salvaged by experts who go and raise it off the bottom doesn't hold for him as a model. Risk mitigants such as variation margin haircutting, allocating a trade and capital losses for shareholders have improved tremendously over the last five years.

There are clearly places where best practice could improve but I feel that CCPs are safer than they have ever been, as a result of having gone through this recent process. Safety, of course, doesn't come without a cost.

WL I want to emphasise that CCPs are doing a much better job. They're putting cash and lines of credit into

"There comes a point where if it costs too much or it's not done in the right way, someone else will set up a competitor."
Bill Templer, Faventus Consulting

the waterfall that can be tapped. The key point is that there needs to be consistency of how this is treated around the world. People will not be as sensitive and mindful of how risk is being managed unless they have something at stake. There should be a consistent standard globally for clearing houses.

Question from the audience You've talked about the risk management aspect of the CCPs and it seems there's no race to the bottom on margin but there is a bit of a race around collateral eligibility perhaps. But that's not really the point. It's more a question of the competition between these guys.

When Eurex win the euro business and CME win the dollar business, what stops them putting up their prices and then changing the rule book themselves by, for example, deciding they will accept clients' cash and give back treasuries in return? That's where the ownership model of the CCPs will come under pressure and I don't see any way out of that with the public ownership model of the CCPs.

BT The regulators determined that they wouldn't let a clearing house abuse its position in terms of competition and how they operate, so they are pretty tightly controlled. But there comes a point where if it costs too much or it's not done in the right way, someone else will set up a competitor. That's what the regulators say.

AB The competition role of the FCA is partly an answer to the issue of dominant pricing and other competition issues – and they will be monitoring behaviours.

JK The liquidity aspect can't be ignored either and we have not yet tested the real relationship between cost and liquidity. It's something that might occur soon given the imminence of SEFs. That's a factor that needs to be taken into consideration because we do not have infinite elasticity around pricing in terms of either what CCPs or FCMs charge.

Question from the audience We've heard a lot about challenges in the industry, specifically in relation to regulatory capital and economic capital. My concern is about human capital. Not enough of us are sufficiently educated, and that is where I feel the FIA and FOA can come in.

Are we in danger of running out of people with sufficient expertise in what we're doing and trying to implement? To what extent will that be the ultimate hamstringing of making the regulator's vision a practical reality? The regulators themselves have their own problems with not having enough people.

BT One issue with that is the closure of floors, which were a great breeding ground for people to learn a lot and move into different roles. Offshoring is another thing that has meant we've lost a lot of natural talent and real understanding of those processes and how the business operates has been lost.

The other one is the replacement of those people with graduate trainee schemes. Graduates come in and go through training schemes in banks and expect that their careers will soar. They don't necessarily want to spend their time doing what they consider to be more mundane jobs or even necessarily working in the futures industry when prime brokerage or something else beckons.

Those things have caused a lot of problems to our industry over time but I'm not sure how you fix it.

AB There is certainly an issue with people fatigue. We're dealing with a needlessly complex regulatory and market change agenda. We are trying to engage in business recovery, business growth, and business expansion and go out and get business. At the same time we've got to deal with an excess flow of regulatory paper. It is all too much!

BT But just to counter, somebody said that the best decisions are made in a constrained environment, and I think that's probably a sensible way to make decisions.

US equity options gear up for OTC clearing

Gary Delany, Director of European Marketing and Education at the Options Industry Council (OIC), explains why CCP clearing will soon be available for OTC US equity options

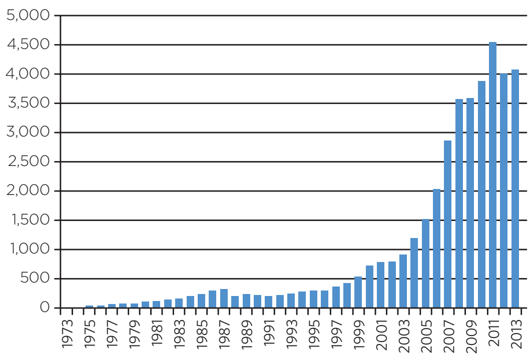
The structure of the financial world in 2014 bears little resemblance to the pre-2008 crash world. To quote the Irish poet WB Yeats, "All changed, changed utterly: a terrible beauty is born." While many would perhaps question the beauty of the emerging market structure, it is undoubtedly different.

Pre-crash, central counterparties (CCPs) were much spoken of as ideal vehicles for risk management, but it took the demise of Lehman Brothers in 2008 for their virtues to be more widely recognised. Since then, regulators have been eager to adopt either an exchange traded or a cleared model for suitable standardised derivatives. This process has not always been smooth, trouble-free or rapid, but progress has been made.

US equity options have a long history of being both exchange traded and centrally cleared. Volumes have risen steadily since their inception in 1973 (see graph). The 12 US equity option exchanges are all cleared by OCC, the world's largest equity derivatives clearing organisation. This structure is often held up as a poster child, delivering fungibility for non-proprietary products, economies of scale in processing and the ability to foster competition and innovation.

OCC Exchange traded equity option volumes 1973-2013

(millions of contracts cleared)



Thus far, CCP clearing has not been available for OTC US equity options. This is about to change. OCC has taken steps to start to apply its proven risk management expertise in exchange-traded US equity index options to the OTC side of the business. It has been working with market participants to build an OTC equity index derivatives clearing solution that delivers capital and operational efficiencies. Testing is now being scheduled with participants to prepare for the upcoming launch.

S&P Dow Jones Indices has licensed OCC to clear OTC options based on certain S&P stock indexes, including the S&P 500®. The S&P 500 is the world's most widely followed stock market index with approximately \$1.57 trillion directly indexed and \$5.74 trillion benchmarked to it, as of 31 December 2012. This is the first time that CCP clearing has been available for options on these OTC S&P indexes. To be eligible for clearing, OTC S&P 500 trades must meet specific requirements. They need to be negotiated and matched OTC; they need to have an expiration date between four months and five years; and they need to meet notional value parameters – e.g. a notional value of \$500,000 times the value of the S&P 500 index for initial maturities between four and nine months (equivalent to a 5,000 lot exchange traded minimum) or \$100,000 times the value of the S&P 500 index (equivalent to a 1,000 lot) for maturities between nine months and three years. There are no notional limits for maturities between three and five years. Purchasers of the OTC options must also be accredited investors and eligible contract participants, and clearing members of OCC must meet other requirements described in OCC's by-laws and rules.

OCC has received US Securities and Exchange Commission (SEC) approval to clear OTC S&P 500 index options. Included in this approval are changes that enable OCC to portfolio margin listed and OTC positions that are held in a single account, which may result in margin offsets and lower margin requirements. OCC received no-action relief from the staff of the SEC's Division of Trading and Markets to permit OTC options to generally be treated the same as other listed options for purposes of Rule 15c3-1 net capital compliance, enabling broker dealers to use an approved theoretical options pricing model to calculate capital charges for positions in OTC options, and market makers to trade in OTC options without making themselves ineligible for capital treatment. Recently approved changes to OCC's margin model for longer tenor options will strengthen risk management across the industry. Finally, a Securities Investor Protection Corporation (SIPC) rule change broadens the definition of "Standardised Options" under the Securities Investor Protection Act (SIPA) to include OTC options cleared by OCC. This approval enhances the protections afforded to customers in the event of a liquidation of their broker-dealer, as OCC-cleared OTC options will now be subject to closeout or transfer in a SIPA proceeding.

OCC will clear OTC options subject to the same basic rules and procedures used in the clearing of exchange traded index options. Each party to an OTC option trade will enter the trade data into MarkitSERV's platform to affirm the trade, which will then process the trade and submit it +to OCC for clearing.

Positions in OTC options will be co-mingled with positions in other cleared contracts in OCC's existing clearing member account structure. Long OTC option positions held in the customer's account will be subject to segregation on the same basis as long positions in listed options. Clearing members will be allowed to carry a customer's positions on an omnibus basis in the customer's account or in individual subaccounts within the customer's account. Customer-level margin will be subject to SRO rules. The minimum capital charge for each OTC option under SEC Rule 15c3-1 will be $0.75, adjusted as appropriate for the size of the OTC option, not to exceed the market value in the case of long contracts in OTC options. OCC's single clearing fund will guarantee OTC options, which will be fungible with each other to the extent that there are OTC options in the system with identical terms.

The emerging framework for the clearing of OTC US equity index options offers the benefit of OCC's financial guarantee and safeguards to mitigate counterparty risk. OCC's efficient model will enable the industry to benefit from low transaction fees. On the capital side, portfolio margining with listed and OTC option positions in one account may result in margin offsets, lowering the overall cost of clearing. Depending on specific transactions, fungibility will also be available.

To close, remember that OCC is a utility clearer. Clearing OTC equity options is not mandated and this is an entirely voluntary innovation. OCC has worked with its clearing members to extend its financial guarantee and central counterparty role for the benefit of the market and its users.

Facing up to the challenges of the new world order

David Setters looks at the challenges, past and future, for Trading Technologies

Trading Technologies (TT) is certainly a survivor in a market which has seen a contraction from about 20 ISVs servicing the futures markets at the turn of the millennium, to probably no more than six truly independent suppliers around today, according to Steve Stewart, Managing Director, Europe, Trading Technologies. And although having fewer ISVs around is an obvious advantage, as Stewart himself points out, many banks continue to develop their own screens and that constitutes much of the ISV's competition.

The main challenge of recent years, however, has been the regulatory change agenda.

"We have huge pressures on us to help reduce technology spend for our clients," says Stewart. "Obviously, we need to work with them on regulatory change but the resources required are massive and the time spent on it certainly doesn't help us work on new initiatives."

The focus on cost efficiencies, however, is beginning to bear fruit for TT along with some of the new functionality which has been introduced, much of it to solve issues arising from new regulatory requirements.

Its "MultiBroker Solution", for example, has seen an "excellent" take-up from both buy- and sell-side firms. Only one platform and one connection is required to trade with multiple brokers and infrastructure costs are borne by TT, thus reducing the number of networks required and reducing start-up costs for participants.

Importantly in today's post-MF Global environment, it also enables buy-side firms to mitigate risk by providing access to multiple brokers.

TT has also been able to refocus on connectivity to both established exchanges and new trading venues over the past year, adding NASDAQ OMX Nordic, IDEM, LSE Derivatives Market and eSpeed plus newer exchanges NASDAQ OMX NLX and Eris Exchange.

Stewart, however, can see one potential cloud on the horizon for ISVs, a result of the fierce competition which has arisen between the leading international exchange operating groups.

"Some exchange operators are doing a lot of development on their own proprietary trading screen and pushing it hard directly to clients," states Stewart. "At the turn of the century, exchanges opened up their APIs because they wanted to have as many people as possible participating in the markets to grow their business. And now it seems to be going the opposite way. They're pushing their own connectivity as a way of keeping the existing traders they already have."

Stewart believes that some exchanges are now alienating the FCMs and going direct to the end-user. "As an ISV we continue to work with FCMs on a partnership basis," he says. "We sometimes conduct joint presentations, even though they too have their own screens. It is understood that we can fill in the gaps that their systems can't provide. We don't see the exchanges working like that.

"Some exchanges originally threatened that there will be no block trading via ISVs," he continues. "Many of our clients are block traders so that would be prohibitive to the market. We also understand that some new OTC instruments will only go through their own platforms, to the point where we'll have to get permission for certain clients to get access."

Stewart readily acknowledges that competition is healthy for business. "That's as true for ISVs as it is for trading venues. At the moment the incumbent exchange groups are starting to restrict competition. They are not targeting the ISVs, they are targeting each other. The battle between the major exchange groups is leading to collateral damage which they don't seem to care about."

"I understand they want to be 'sticky'," he continues. "They don't want business to go elsewhere, but if they don't allow people to trade multiple markets it will restrict competition and once business is 'trapped' the cost of trading can go up. Building a revenue stream has become far more important for them. It's a defensive move against the competition. And what is more, restricting access in this way also seems to go against the key motive behind MiFID II of opening up the markets to competition."

"Screen 'real estate' on traders' desks could multiply," he believes. "Where a client wishes to trade two products in the same sector, for arbitrage purposes for example, he will need two different screens, two different risk systems and to learn two different functionalities. It's potentially yet another cost headache for our clients."

In an industry that is starting to see the shoots of recovery, technology is going to play a big role in helping us and it is imperative that we embrace it.

FOA news

RESPONSES TO REGULATORY PAPERS & POSITION PAPERS

February 2014

Proposal for regulation of EU Parliament and Council on Benchmarks final – 31 January 2013.

February 2014

Appendix 2 – Price Indices Guidelines for Price Aggregators and Data Providers – November 2011.

January 2014

FOA Response to CP13/14

NEWS

January 2014 FOA announces change of leadership

NEW FOA MEMBERS

We are pleased to welcome the following new members:

- Akin Gump LLP
- Danske Bank A/S
- Eurex Clearing AG
- Futures Industry Association
- Gekko Global Markets Ltd
- HETCO Advisory Services U.K. Ltd
- Lloyds Bank Commercial Banking
- Saxo Capital Markets
- The Toronto-Dominion Bank
- Thomas Murray Data Services
- Trafigura Derivatives Ltd
- TriOptima AB

FOA events calendar

■ Power Trading Forum
Thursday 20 March ~ Dentons UKMEA

The Forum will focus on Ofgem liquidity intervention, market coupling and power market transparency.

■ IDX 2014
Tuesday 10 & Wednesday 11 June ~ The Brewery

The FIA and FOA are pleased to present the seventh International Derivatives Expo. Last year's event welcomed more than 1,000 delegates, over 40 exhibitors showing the latest products, services and technology for the derivatives industry and 20+ sessions with high-profile speakers, information-packed workshops and valuable networking opportunities.

■ IDX Gala Dinner 2014
Wednesday 11 June ~ The Pavilion at the Tower of London

The IDX Dinner will once again be held in aid of Futures for Kids. The Dinner also provides a valuable networking opportunity for those attending IDX and the wider international community.

■ Power Trading Forum's Away Day
Thursday 10 July ~ Drax Power Station, North Yorkshire

FOA is pleased to announce a visit for Forum members to Drax Power Station, the largest, cleanest and most efficient coal-fired power plant in the UK.

■ FOA's Annual Power Trading Dinner 2014
Thursday 16 October ~ The Savoy, London

Now in its 12th year, this black-tie dinner provides a valuable networking opportunity for members of the power and energy trading community.

■ FOA's Clearing & Technology Gala Dinner 2014
Wednesday 3 December ~ Artillery Gardens at the HAC, London

Following the success of the inaugural dinner in 2013, the event provides a networking opportunity for the futures industry's clearing, operations and technologies communities.

■ 2014 Compliance Forums
Thursday 27 March ~ venue tbc
Thursday 29 May ~ venue tbc
Thursday 31 July ~ Norton Rose Fulbright
Thursday 25 September ~ J.P. Morgan
Thursday 27 November ~ Norton Rose Fulbright

Topics to be confirmed.

FFK calendar

Futures for Kids

■ Quiz Night
Thursday 3 April ~ Minster Exchange

■ Golf Day
Friday 4 July ~ Brocket Hall

■ Poker Night
Thursday 2 October ~ venue tbc

For more information on all events, including sponsorship opportunities, please contact Bernadette Connolly on connollyb@foa.co.uk or +44 20 7090 1334

■ FORTHCOMING INFONETS
Trading & technology execution
Thursday 1 May ~ Grocers Hall, London EC2

Trading firms, exchanges, brokers and vendors look at how their businesses are changing and what is changing them.

New products and new markets
Tuesday 8 July ~ Grocers Hall, London EC2

Despite the recent focus on regulatory change the industry must innovate to survive and grow. Industry specialists look at where that growth will come from by asset class/geography and also analyse the IT and operational challenges of accessing and distributing them.

Who can attend? This event is open to executives at FOA member firms and to specially invited guests of the FOA and InfoNet Sponsors.

For further details or to reserve a place, please contact Bernadette Connolly on connollyb@foa.co.uk or +44 20 7090 1334