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Blizzard of regulation has its effect

Oivind Hovland

As lawmakers' plans to make the system safer start to emerge, so too do the industry's responses, writes *Philip Stafford*

For those in trading, exchanges, clearing and settlement gathered this week at two conferences on either side of the world, this has been a sobering year. Executives meeting at the Futures Industry Association's "Expo" in Chicago and Swift's Sibos post-trade services event in Osaka have struggled for three years with persistent declines in volumes, as the low interest rates and worries about the global economy discourage investors from trading.

That in turn has crimped profits for most exchanges and the banks that serve as the middlemen on global markets. But it could also be said that the blizzard of tough global regulation intended to safeguard the world's financial system began to make its presence felt for the first time.

"The lightbulb over people's heads is probably burning at 15 watts right now. That lightbulb is going to get a lot brighter," says Jerome Kemp, global head of over-the-counter (OTC) derivatives at Citigroup.

After the financial crisis, G20 countries mandated a wide-ranging overhaul of the OTC derivatives market, with more trades pushed on to transparent electronic trading venues and deals processed through clearing houses, which act as insurance for deals. That resulted in legislation such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US. Europe is further behind

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Increase in competition raises the stakes

The US

Exchanges are hit by profit and volume falls, not to mention more trading venues, says *Arash Massoudi*

The leading US stock exchanges have had a difficult year, and there are few signs to suggest business is going to recover.

For a fourth consecutive year, equity volumes on the US market are set to decline, so placing pressure on the bottom line at New York Stock Exchange and Nasdaq.

The growing portion of transactions has shifted to private trading venues such as dark pools, where trades are posted to the public market only after they have occurred.

"Exchanges have been hit with a double whammy," Justin Schack, managing director at Rosenblatt Securities, says. "Volumes have dropped and their share of those volumes has also declined."

Meanwhile, the special status accorded to exchanges is being questioned after events this year have highlighted the complications of being a for-profit trading venue while also regulating activity.

Shares in NYSE Euronext and Nasdaq OMX, parent companies of the exchanges, have lost 5 per cent and 2.5 per cent respectively from the start of the year, even as the broader US equity market has gained 12 per cent.

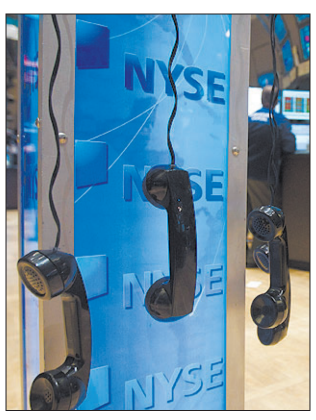
Transactions in the third quarter on the NYSE and Nasdaq were down 13 per cent from the previous quarter and 32 per cent from the same time a year ago, according to figures from analysts at Sandler O'Neill.

Exchanges are caught in the difficult position of trying to regain market share with prospects appearing bleak, some analysts say.

"If the volumes stay at current levels, I think exchanges will probably need to make some pretty hard decisions," says Miranda Mizen, director of equity research at Tabb Group, the capital markets consultancy.

As they try to defend what has typically been the lifeblood of their business, the exchanges have sought to attract new sources of revenues by providing services beyond transactions.

But that has not gone smoothly as technical mishaps have plagued recent efforts, opening up a new line of attack on their traditional business model.



Hanging on the line: volumes are down at the NYSE

In May, a technology glitch at Nasdaq hampered the flotation of the Facebook public offering on its exchange. The event was a black eye for Nasdaq's listing business, and brokers are still seeking to recoup $500m in losses they say were caused by the debacle.

Subsequently, exchanges' self-regulatory status has come under fire from brokers, and some regulators, who say the special privileges no longer apply to the modern market in which NYSE and Nasdaq are for-profit entities.

In October, Daniel Gallagher, a commissioner at the Securities and Exchange Commission, said the provisions were outdated and needed to be reviewed.

> 'I think exchanges will probably need to make some pretty hard decisions'

"As public companies, the exchanges are dealing with more pressure because they are a profit-centre rather than a public utility as they once were," says Richard Repetto, analyst at Sandler O'Neill.

In September, a $5m fine levied against NYSE by regulators indicated that the SEC would also be looking to punish any exchange transgressions.

The financial penalty was the first levied against a US exchange as the company agreed to settle allegations it had improperly favoured certain customers with critical data that could have allowed for millisecond trading advantages.

The exchanges have sought to regain market share lost to venues such as dark pools, which have become a preferred site for many of Wall Street's largest trading customers wanting to unload or purchase stocks without influencing the price.

Adding to the pressure, securities brokers have sought to internalise trades, matching buy and sell orders within their own networks, further depriving exchanges of activity.

Mr Schack says the rise of these venues has forced exchanges to take the difficult line of trying to mimic their new competitors, which face less strict regulatory requirements, while publicly arguing for a more level playing field.

"One of the ways they are doing it is by lobbying for changes to existing rules, which would enable them to better compete against dark pools," Mr Schack says.

The exchanges complain that adapting their business to new challenges has been hampered by a sluggish process whereby regulators must approve initiatives.

NYSE Euronext finally received approval for its so-called "retail liquidity programme", which allowed it to offer specially designated market-makers trades at sub-penny prices, a feature that was previously exclusive to non-exchange venues.

The success also put Duncan Niederauer, chief executive of NYSE Euronext, in the contradictory position of arguing in favour of "bringing dark pools into daylight", even as his company has sought to dim the lights at his own exchange.

Even worse, a high-profile trading mishap at Knight Capital, an electronic trading and market making company, overshadowed the first day of trading under the RLP. A software error as Knight's systems tried to game the RLP on August 1 left the company with a $460m loss, taking it to the brink of bankruptcy.

From the perspective of exchanges, it had the unfortunate effect of once again inviting deeper regulatory and investor scrutiny of the trading business at a difficult time.

Marianne Browne, chief executive of Omgeo, a post-trade services company, says: "The ultimate question for exchanges has become whether they continue to define themselves solely as marketplace utilities, or whether they can evolve into something else altogether – in most cases they seem to be focusing more on technology."

Asia watches and learns from European and US rulemakers

OTC derivatives The region is not looking to choke nascent markets, reports *Jeremy Grant*

Asia may make up about only 8 per cent of the $648tn in notional value traded in the over-the-counter (OTC) derivatives market, but that does not mean the region is standing idly by as waves of regulations wash over the industry.

Just as banks, brokers, exchanges and clearing houses are bracing for the implementation of the US Dodd-Frank act, and a knot of European rules with similar aims, the region is busy with initiatives of its own.

They are designed to ensure compliance with the mandate agreed at a G20 meeting in 2009 to shift the bulk of OTC derivatives on to exchanges or other electronic trading platforms.

They are also to ensure that many such instruments be processed through clearing houses to help safeguard the financial system against the fallout from another big default after that of Lehman Brothers in 2008.

Yet regulators in Asia are not simply copying what is happening in the west. There are clear signs the region is cherry-picking the best elements of the new US and European regulations and avoiding perceived mistakes.

In Singapore, home to a large community of OTC interest rate swaps traders and an exchange that started an OTC clearing service as far back as 2010, the authorities have avoided rushing regulation.

That is because the city state feels it needs to balance a commitment to meeting the G20 mandate with a need to avoid choking its own nascent OTC derivatives markets.

The Monetary Authority of Singapore has kept its counsel on whether OTC derivatives should be traded on electronic platforms. But it has thrown its weight behind mandatory clearing.

Singapore has also allowed The Depository Trust and Clearing Corporation, the US-based post-trade group, to establish its first Asian trade repository for OTC derivatives there.

Mike Bodson, DTCC chief executive, says the region's ability to manage the risks often associated with OTC derivatives will play an important role in protecting Asian markets from "repeating the mistakes" of other financial centres.

"Asia is well positioned to seize a greater share of the OTC derivatives market, while at the same time having the right tools in place to protect it from the risks that nearly led to the collapse of the global financial system," he says.

Such a nuanced stance comes as competition is emerging in Asia for a share of the OTC clearing business, meaning that competition within Asia to capture a share of what is expected to be lucrative business will continue to spur clearing initiatives.

This month the Japan Securities Clearing Corporation started clearing yen-denominated interest rate swaps, the largest by value traded of any OTC derivatives in Asia.

Hong Kong Exchanges and Clearing is busy refitting its clearing house to handle OTC swaps, with a focus on renminbi-denominated products that are expected to grow as China expands the use of its currency in financial markets.

Talking legislation: Gary Gensler, chairman of the Commodity Futures Trading Commission
Bloomberg

This quarter, the Hong Kong Monetary Authority and Securities and Futures Commission plan to introduce a bill into the Legislative Council to provide a regulatory framework for the OTC derivatives market in Hong Kong.

And in South Korea the KRX exchange is also working on offering OTC interest rate swaps clearing.

But, in the meantime, one big uncertainty is how US regulations will affect the region. Asian regulators worry that market participants outside the US may end up being caught by Dodd-Frank as well as domestic rules, causing "market fragmentation and, potentially, systemic risk", according to watchdogs in Singapore, Hong Kong and Australia.

In August they expressed such concerns in a letter to Gary Gensler, chairman of the Commodity Futures Trading Commission, the US regulator fleshing out how Dodd-Frank will be implemented.

Lack of clarity over whether and how Dodd-Frank might apply to swaps dealers extraterritorially means banks would be forced to comply with two sets of "overlapping and conflicting" regulations in the US and in their home country, the watchdogs wrote. That could have "unintended consequences" for the three jurisdictions' markets.

In the case of the JSCC in Tokyo, for example, the clearing house would not be able to offer clearing of a deal where a US entity was on one side of the transaction, without the JSCC having status in the US as a designated clearing organisation. The JSCC has applied for that status, but in the meantime faces uncertainty.

Smaller Asian states are also worried. The Financial Stability Board in July said some emerging markets – singling out Malaysia – were concerned about unresolved issues with OTC derivatives reforms that prevented them from deciding what kinds of clearing houses and trade repositories to create.

Donna Bales, managing director of Balmoral Advisory, a consultancy in Singapore, says many smaller nations "have aspirations to grow their markets and they are genuinely supportive of the global reforms. However, they need to understand the full impact on their financial systems."

Fight looms over which model is best

Swaps market

The sector has been preparing for Sefs but an alternative is gaining ground, says *Michael MacKenzie*

A new era is close at hand for the US derivatives industry and the battle lines are being drawn up over two very different approaches to how the vast swaps market will trade in the future.

In the wake of the financial crisis, regulators have pushed for a transparent and safer over-the-counter (OTC) swaps market. Under the 2010 Dodd Frank Act, the solution has been a move towards clearing the credit risk of swaps in conjunction with fostering electronic trading that encourages live prices being widely publicised.

In the coming months clearing begins in earnest and the US Commodity Futures Trading Commission is expected to finalise swap trading rules for new venues, known as swap execution facilities, or Sefs.

While the swaps industry has long been preparing for the arrival of Sefs, an alternative way of trading is also gaining momentum, the designated contract market (DCM), or listed futures exchange model.

For more than two years, the swaps industry has aggressively lobbied the CFTC, Congress and other regulators with the aim of preserving much of the existing swap trading model via Sefs. Those efforts have sought to forestall OTC swaps from trading like interest rate futures, where trade sizes are smaller and transactions more frequent.

But the ground is already shifting beneath the swaps industry with the Chicago-based CME, the largest US derivatives exchange, set to start trading a swaps future contract via a DCM with the help of banks such as Goldman Sachs, Credit Suisse, Citigroup and Morgan Stanley.

The move is seen as a shot across the bows of the nascent Sef model and suggests some banks are taking an open view as to how the swaps market will develop.

"The swap market is going to change, the current status quo will not survive," says the head of electronic trading at a big dealer that will make prices for the CME's swap future.

This month, Tabb Group, the consultancy, released a report called "The Death of a Sef" that argued the DCM model is better placed to capture electronic swaps trading. "The enthusiastic start-ups have been beset by delayed regulatory timelines and entrenched behaviours, but also by being in the no-man's-land of trading venues," says Tabb. "Sefs have the same amount of regulatory burdens as an exchange, a narrower slice of the derivatives market and will largely depend on the survival of the status quo."

DCMs also have an advantage over Sefs in being allowed to set the size of large swap trades on their platform. That could encourage large institutional investors to trade on DCMs rather than Sefs, which face stricter rules.

"We are seeing the proliferation of new futures products," says Donald Wilson, chief executive at DRW Trading Group, which cofounded the Eris Exchange that supports swap futures.

IntercontinentalExchange plans to introduce a future for credit derivative indices next year. Meanwhile, ICE and the CME plan to convert cleared energy OTC swaps to futures so that investors and traders can avoid tougher capital rules.

For prospective Sefs, frustration with the delay in approving rules combines with concern that DCMs may have an advantage.

"Every day that goes by without clarity on rules is bad for transparency and the democratisation of the swaps market," says James Cawley, chief executive at Javelin, a nascent Sef.

Other prospective Sefs are ready to revise their models. Vinayek Singh, chief executive at Vyapar Capital Market Partners, says that while it has been preparing to register as a Sef, the current uncertainty across the swaps industry requires a flexible approach.

"If DCMs end up covering most of the standard market, that's where dealers will transact. We are prepared to modify our approach, either as a Sef or as a DCM," says Mr Singh.

Lee Olesky, chief executive at Tradeweb, the electronic trading platform,

> 'Every day that goes by without clarity on rules is bad for transparency'

says: "We currently plan to register as a Sef." However, should the OTC market develop over time towards a DCM model, Mr Olesky says they would evolve with the market.

But he says pushing swaps towards just one type of model is unwise: "It's not a one size fits all market."

Chris Ferreri, managing director at ICAP, the inter-dealer broker, says moving the swaps market towards a futures-style market raises questions for the industry about stifled innovation and reduced competition among trading venues as a futures contract trades only at the exchange it originated in.

A bigger concern is the dilution of tailored swaps that offset specific interest rate risk. Once interest rates rise, many investors may be caught out by relying on a future rather than a swap that better matches their interest rate risk.

Mr Olesky says: "It makes sense to have a variety of options to trade swaps in order to create a stable environment that meets customers' differing needs."

Mr Ferreri adds: "Large asset managers, for example, make use of swaps as a way to precisely mitigate risk and that is not as easily achieved through futures."

Moscow tie-up wins approval from participants

Russia

Concerns about a lack of competition are outweighed by liquidity hopes, says *Courtney Weaver*

Russia's dream of turning Moscow into an international financial centre is starting to look more realistic thanks to the tie-up of the country's two main indices, Micex and RTS.

Since the exchanges merged last December, Russia has begun pushing through a series of long-awaited reforms investors hope will increase liquidity, make trading more reliable and open up the Russian market to a new class of participant.

Early next year, for instance, Russia will for the first time have a central securities depository, which will cover the entire Russian stock market by the end of 2013, says Alexander Afanasiev, chief executive of the new Moscow Exchange. Other changes include a law on clearing that will come into full force in January, and the establishment of so-called t+n settlement, which will allow market participants to settle trades within two or three days, according to European and UK standards, as opposed to a policy of same-day settlement.

While some reforms have taken longer to enact than most people would like, market participants are largely positive about what the enlarged platform will mean for making Russia a viable trading centre.

Alexander Branis, director of Prosperity Capital Management, says: "You always have this combination of best intentions and less than perfect implementation. Best intentions are still there and, I think with time, they will get their act together and actually deliver."

Some had worried that linking Micex and RTS would decrease competition. But these concerns appear to have been outweighed by the benefits of having a single liquid exchange.

Mr Branis says: "On the one hand RTS and Micex competed against each other and in some ways it helped innovation because they had to come up with new products, new services all the time in order to compete. At the same time I think concentrating liquidity under one roof, one exchange, is an advantage."

Mr Afanasiev admits the merger has not been easy, given the different backgrounds and cultures of the two. Micex, for instance, historically had a "more conservative culture" and was "more about risk management", he says. RTS, on the other hand, catered primarily to brokers who cared more that the exchange was "flexible and reacted quickly".

"Business culture is not something we can implement artificially top-down," Mr Afanasiev says. The exchange is dealing with reforms step-by-step to ensure it acts as an integrated platform and not simply two distinct indices within one larger holding company, he says.

The Moscow Exchange

According to Mr Afanasiev, the Moscow Exchange has survived the recent months of market volatility because of its diverse range of products. While revenues have decreased on the exchange's equity and derivatives markets, this drop has been more than made up for by increased turnover on the foreign exchange and money markets.

As to the future, the main questions revolve around the Moscow Exchange's management, its commitment to wider market reforms and also an initial public offering, planned for 2013.

Mr Afanasiev was promoted to chief executive in June after the board decided the roles of president and chief executive should be divided between two people. Ruben Aganbegyan, who pioneered the Micex-RTS merger and had been filling both of these positions, left the exchange shortly afterwards.

Mr Afanasiev says the management changes made sense as it was better to have one person – the chief executive – to focus on the exchange's day-to-day operations, and a second – the president – to concentrate on the broader agenda of market reforms.

But the abrupt management restructuring left some investors perplexed. "I don't think it was explained very well why that happened," says Roland Nash, chief strategist at Verno Capital, a Moscow hedge fund. "It doesn't undermine the arguments. It just adds another level of unnecessary confusion."

Finding a president will be a key step for the exchange before any IPO.

"The IPO is important to make Moscow Exchange an open and listed company. It is one of the very few big exchanges worldwide that is not listed," Mr Afanasiev says.

For now, investors hope he and his colleagues will lobby for the planned reforms to be enacted smoothly and quickly.

The creation of the central depository, for instance, will "create the ability for a new class of institutional investors to trade directly in Russia", Mr Nash says, another step towards greater liquidity.

There are complaints that more could be done, and done more quickly. However, as Mr Nash adds: "The best news is that the merger has taken place… and a lot of the reforms that were being discussed a couple of years ago have progressed."

Once-neglected segment is now banking's belle of the ball

Transaction banking

Daniel Schäfer finds large institutions are seeking to make money in less volatile sectors of the market

In the course of just a few years, transaction banking has stopped being an ignored Cinderella and turned from a dull business into one of the sector's hottest growth areas.

A label for many products, from cash management, trade finance and securities custody to card payments, it has grown quickly and is achieving profits investment bankers can now only dream of.

"Banks are talking about it as the holy grail of the industry," Samir Assaf, HSBC's chief executive of global banking and markets, says. "They have experienced the volatility of investment banking and so they turned to transaction banking, which is much stickier and has both interest and fee income."

With the exception of trade finance, transaction banking consumes a very low level of bank capital and can therefore produce returns on equity of up to 60 per cent – which compares with the single-digit percentage rates that have become commonplace in the investment banking world. Deutsche Bank, for example, uses 7 per cent of its risk weighted assets – a measure for the amount of capital that underpins a banking business – for global transaction banking. At the same time, the business unit accounts for 18 per cent of its overall earnings.

John Gibbons, head of JPMorgan's treasury services in Europe, the Middle East and Africa, says: "It is a strong business in that it requires relatively little capital and provides a constant revenue stream."

But to process trillions of cash and securities transactions, from credit card payments to share purchases, you have to have scale and investment power. Citigroup, one of the leading protagonists in the global market, spends $1bn a year on IT in its treasury and trade solutions segment.

"You have to make huge technology investments," Mr Assaf says. "You also need to have a global network, a good rating and a solid capital position." Bankers say it can easily take 10 to 15 years for a newcomer to make technology investments pay off.

Some medium-sized banks have started to source transaction banking products from larger rivals as a result. For the international banks that are the biggest competitors in this field, it is a nicely shielded market that resembles an oligopoly.

At HSBC, combined revenues last year for such services were about $10bn – a sixth of its overall revenues. It is among a handful of banks, including Citi and JPMorgan, that dominate the area, with Bank of New York Mellon and State Street, which are strong in securities services.

Deutsche Bank's revenues of €3.6bn in the market are still dwarfed by the market leaders, but it is keen to diversify away from volatile investment banking. It wants to double its transaction banking earnings in the next three years.

Buying ABN Amro's transaction banking unit a few years ago still has not paid off, and it now concentrates on organic growth by investing an extra €150m each year and hiring 250 more bankers.

Most banks aim to grow with existing clients and by setting up branches across the globe. JPMorgan has this year launched transaction banking services at locations in South Africa, Saudi Arabia, China, Russia, Kenya and Ghana.

However, the segment is not immune from the headwinds that the financial services sector now faces.

> 'You need to have a global network, a good rating and a solid capital position'

One of the key issues is compliance and regulation. US investigations against HSBC over alleged money laundering activities connected to illicit narcotics has been a reminder of the risks and compliance challenges for banks.

"Know Your Customer" (KYC) policies today force banks to use software to identify risky or suspicious client accounts to combat money laundering and the financing of terrorism.

This comes at a price. Bankers estimate KYC has increased IT costs in the transaction sector by 10 to 15 per cent.

Citi, for example, puts about 6,000 lines of software code into production every week to ensure its systems remain in regulatory compliance on a global basis.

Rajesh Mehta, Citi's head of treasury and trade solutions in Europe, the Middle East and Africa, says this has prompted banks to consider working together on software to slash costs.

The other serious threat stems from the new rule book for capital, liquidity and leverage levels. This incoming Basel III regulation is set to make trade finance more expensive and less profitable.

While transaction banking has been a lucrative area for banks recently, it remains to be seen if this Cinderella will be able to live happy ever after.

Foreign rivals join battle for post-trade prize

Monopoly position: analysts say greater competition in the market is inevitable but is unlikely to happen before 2015 Reuters

Brazil *Samantha Pearson* finds that moves to infiltrate the market could meet resistance

Clearing houses, the institutions that ensure trades are completed even if one party defaults, are not normally the source of much controversy.

In Brazil, however, they have become the battleground for a bitter struggle for control over one of the world's most prized markets.

BM&FBovespa, the product of a merger in 2008 of Brazil's Bovespa stock exchange and the BM&F futures exchange, holds a near monopoly on equities and derivatives trading in the country. The exchange operator is already the world's third-biggest by market value and expected to benefit as more companies and investors flock to the stock market. Only 30 per cent of the 1,000 biggest companies in Brazil are currently listed on the stock exchange.

Although US stock exchange operators Direct Edge and BATS Global Markets have announced plans to set up trading operations in Brazil, their efforts have so far come to very little as they have no viable way of clearing those trades.

Setting up their own post-trade services would be costly and likely to meet resistance from CVM, Brazil's Securities and Exchange Commission. Meanwhile, BM&FBovespa is under no pressure to share its in-house clearing services with rivals.

Edemir Pinto, BM&FBovespa's chief executive, says it is also unclear whether the regulator has the legal right to force it to outsource services.

"The legislation concerning this is written in such a way that there are lawyers on either side of the fence," Mr Pinto says. "There is doubt over whether the regulator can force the exchange to offer up its services.

"But if the regulator does take the decision that we should offer our [clearing services] then since they are the regulator we would have the common sense to obey," he says.

'There could come a point where the exchange actually benefits from a competitor because of the revenue it brings'

After increased interest from foreign exchange operators in the Brazilian market, CVM announced in June that it had contracted Oxford-based consultancy Oxera to assess the benefits of allowing new operators into Brazil.

Oxera's findings appeared to support the case of hopeful newcomers such as Direct Edge and BATS, concluding that although greater competition could raise regulatory costs it would benefit investors and boost economic growth.

"There seems to be scope for a reduction in fees that will ultimately benefit investors," Reinder van Dijk at Oxera wrote recently in an FT column. "This could also have a positive impact on the wider economy by reducing the cost of capital for listed companies and therefore stimulating investment," he said.

However, CVM has indicated that fostering greater competition in the Brazilian market is not one of their priorities right now.

Mr Pinto says BM&FBovespa's current projects to overhaul the exchange, including the integration of the operator's four clearing houses, make it difficult to offer services to third parties until the middle or end of 2014.

"CVM understands that we have this integration project and all the investments we are doing as part of it," says Mr Pinto.

Last November BM&FBovespa announced that it had contracted Sweden's Cinnober to supply technology for the integration of its clearing houses for government bonds, derivatives, foreign exchange and equities.

BM&FBovespa has also been working with its partner CME to develop Puma, a multi-asset, high-speed trading platform. By the end of next year, it will have invested about R$1.8bn ($885m), of which R$1.1bn will have been spent on technology, says Mr Pinto.

However, BM&FBovespa's investment plans have only prolonged the stalemate in the market. Originally, Direct Edge, which ranks as the fourth-largest US stock exchange operator, planned to launch an electronic equities trading platform in Rio de Janeiro in the fourth quarter of this year.

Now William O'Brien, Direct Edge's chief executive, says he hopes to be operating in Brazil by 2014.

While he has approached BM&FBovespa "multiple times" to get the incumbent operator to open up its clearing services, Mr O'Brien says he has not been able to reach an accord with Mr Pinto.

Meanwhile, BATS also challenged BM&FBovespa's monopoly in February last year, announcing plans to team up with Brazilian asset manager Claritas to create a new Brazilian stock exchange.

However, last month local media reported that BATS had put its plans on hold. BATS responded in a statement to the FT, saying it "remains interested in Brazil".

Rodolfo Amstalden, an analyst at Empiricus Research in São Paulo, says that greater competition in the market is inevitable but now unlikely to happen before 2015.

"There could come a point where the exchange actually benefits from a competitor because of the revenue it brings," Mr Amstalden says, adding that post-trade services such as clearing are already one of BM&FBovespa's biggest revenue sources.

"In our scenario, we believe there will be competitors on the trading side within 10 years and, although it's difficult to judge now, it is more likely to be a company that specialises in a niche service such as high-frequency trading," he says.

Such a company could also prove beneficial to BM&FBovespa by bringing a fresh portfolio of clients from abroad, Mr Amstalden says. "For the moment, though, BM&FBovespa is much better off being a monopoly."

Blizzard of regulation starts to have an effect

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with equivalent reforms embedded in the European Market Infrastructure Regulation (Emir) and a new version of the Markets in Financial Instruments Directive (Mifid). Singapore, Hong Kong and Japan are all following.

Key details of reforms are emerging and so is the industry response.

Definitions relating to swaps passed by the Commodity Futures Trading Commission prompted IntercontinentalExchange and CME Group, two of the world's largest derivatives exchanges, to begin transitioning popular cleared swaps products such as energy and physical commodities into futures contracts.

In Europe, activity has centred largely on London as infrastructure is put in place. The London Stock Exchange is nearing a deal to buy a controlling stake in LCH.Clearnet, the Anglo-French group. Deutsche Börse is also launching an OTC derivatives clearing service, while CME and Nasdaq OMX plan derivatives trading venues.

"The driver of growth is where our clients are and how we approach them," says Bob Ray, chief executive of CME Europe, CME's planned European derivatives exchange.

"If you build your business plan on regulatory arbitrage, it will be a flawed plan – as things could change," Mr Ray adds.

Most bourses are developing their own services rather than buying rivals. Big, cross-border industry mergers have been off the agenda since authorities blocked potential deals that would have brought together NYSE Euronext and Deutsche Börse, and Singapore's SGX and Australia's ASX respectively. Completed deals, such as the merger of Russia's Micex and RTS, have tended to be within national borders, backed by political will.

The OTC derivatives market has begun its move towards central clearing. Many brokers trading interest rate swaps already offset their risk that way, although clearing by users on the buyside, such as pension funds and asset managers, is still in its infancy.

But it is also clear this year that the industry is beginning to worry about the potential effects of other tough regulation not directly aimed at it, such as the Basel III rules requiring banks to maintain consistent higher-quality capital


Bob Ray, CEO of CME Europe

buffers, and the incoming Volcker rule in the US banning proprietary trading.

Derivatives market reforms have raised counterparties' requirements to post high-quality assets as collateral, irrespective of whether trades are processed in a clearing house or not. However, key middlemen – banks – are faced with Basel III's requirements to hold liquid assets rather than lend them, while they are allowed fewer opportunities to make money from trading.

This has led to concerns about a shortfall in collateral, the insurance for trading. Estimates of how much is needed to comply with

'Our job is to make sure this regulation is connected and the client is depending on us'

mandatory clearing vary but the figure has been put at between $1tn-$2tn.

Nevertheless, its effect is reverberating through the market plumbing.

"Everyone is thinking about how regulation affects them but these are the unintended impacts of other regulation," says Jonathan Herbst, partner at Norton Rose, a law firm. "Clients often ask about their unknown unknowns. If you're a clearing house for example, you have to worry about what your clients are worrying about."

As the industry searches for acceptable collateral, custodian banks and settlement houses such as Clearstream and Euroclear, and central securities depositories place emphasis on clearing and settlement services, designed to make more efficient use of clients' existing resources.

"Post-Lehman, risk is on clearing houses. They're well equipped to handle it but what happens if there's an outage?" asks Satvinder Singh, head of trust and securities services at Deutsche Bank. "Our job is to make sure all this regulation is connected and the client is depending on us to make those connections."

Others worry about possibly conflicting approaches taken by G20 countries towards fulfilling the mandate. "Harmonisation is the big issue," says David Wright, secretary-general of the International Organization of Securities Commissions, which represents national securities regulatory authorities.

The futures industry is also recovering from setbacks. A year ago investor confidence took a hit when MF Global, one of the world's largest futures brokers, collapsed, leaving a $1.6bn shortfall in customer funds. No charges have been brought against its executives. Customers are still awaiting the full return of their funds while the trustees of the US and UK businesses are set to meet in court next year.

A second scandal emerged in May at a smaller futures broker, Peregrine Financial, when the chief executive admitted stealing customer funds.

In Europe, fundamental questions about the nature of the market remain. Commission proposals to open up clearing houses have prompted concerns the reforms would fragment liquidity in listed derivatives when regulators are concerned about the negative effects of fragmentation in the equities market, particularly in the US.

There, regulation mandating competition to incumbent stock exchanges has presaged the development of high-frequency trading. Critics have questioned whether it damages market quality. However, its use of superfast technology has led to a race as the rest of the market tries to keep up and has resulted in several technology glitches.

The most eye-catching of these was in August when bugs in a software program rolled out by Knight Capital, the electronic marketmaker, sent out errant prices on more than 140 stocks on the New York Stock Exchange. In 45 minutes Knight had lost nearly $10m a minute, which threatened the group's survival.

The changing of market structures often leads to unintended consequences.

Exchanges, Trading & Transaction Services

Rules covering derivatives built on ground that has yet to settle

Europe What appeared to be firm markers have shifted in just months, says *Philip Stafford*

As he quashed the planned merger between Deutsche Börse and NYSE Euronext in February, Europe's top antitrust official appeared to lay down markers for the region's derivatives markets. "These markets are at the heart of the financial system and it is crucial for the whole European economy that they remain competitive," declared Joaquín Almunia, European competition commissioner.

At the time it seemed to send a signal to the world's exchanges about how European authorities saw the future of the markets it oversees as the industry goes through sweeping change. The deal would have created the world's largest equities and derivatives exchange but the commission said it would have resulted in a "near monopoly" in the trading and clearing of exchange-traded derivatives. In reaching its verdict, it waved away arguments that derivatives trading was global and frequently conducted off-exchange.

Yet within months industry initiatives and policy formulations elsewhere within the EU have potentially blurred those lines, and the ones that separate the listed derivatives market, conducted on exchanges, and the bilateral over-the-counter (OTC) market. For Deutsche Börse, NYSE Euronext and the world's other main exchanges and clearing houses, the motivation behind a concerted focus on derivatives lies in the market safeguards being put in place after the financial crisis.

G20 countries want to push more of the vast OTC derivatives market on to electronic trading venues such as exchanges, and process trades through a clearing house, which stands between two parties in a deal and guarantees a trade in the event of a default. Full details of Europe's response to the G20 mandate – contained in the European Markets Infrastructure Regulation (Emir) – have yet to be fully worked out but the industry has pressed on.

In February NYSE Euronext announced plans to expand its London-based derivatives clearing operation, redirecting some business that had formerly flowed to LCH.Clearnet, the Anglo-French clearing house. Since then the London Stock Exchange agreed to buy a controlling stake in LCH while Nasdaq OMX confirmed it would start trading interest rate swaps in direct competition with Deutsche Börse and NYSE Liffe.

Deutsche Börse announced plans to follow CME Group, the US futures exchange operator, in offering interest rate swaps clearing in Europe. Rounding off the six-month flurry of activity, the CME filed an application with UK regulators to begin a London-based derivatives exchange that would start with foreign exchange derivatives, putting it into battle with LCH.Clearnet.

"The certainty is that clearing is going to continue," says Mark Ibbotson, co-chief executive of NYSE Liffe. "That's created new opportunities both offensively and defensively. We knew that those who had assets in infrastructure would deploy them."

However, the ground these foundations are built on is yet to settle. The European Commission, which proposes policy, wants open access to exchanges' derivatives clearing services as part of a review of its Markets in Financial Instruments Directive (Mifid). Critics say the vertical silo business model, as used by Deutsche Börse and NYSE Liffe, is a barrier to competition as it makes it hard to offer trading in the same derivatives offered by the silo.

Yet the need to balance the commitment to the G20 mandate threatens to dilute the principle the commission has sought to introduce. Deutsche Börse and NYSE Liffe say opening up access to their clearing houses and introducing fungibility to contracts cleared there could also increase market instability as well as tie up the liquidity of its clearing members. That is because, unlike equities, open-ended derivatives contracts can remain on clearing houses' books for months and require daily risk management of positions and margins.

The arguments have had some force. A similar article to the commission's Mifid proposals was watered down in Emir, as was the article in the text agreed by the European parliament in late September. Europe's stance will only be thrashed out after a three-way dialogue between the commission, the Parliament and the Council of Ministers, and implementation may not come until 2015.

"The balance between safety and competition is being defined in individual items of legislation, in a piecemeal and potentially uneven manner," said Peter Norman in a report for the Centre for the Study of Financial Innovation, a UK think-tank.

Mr Norman has called for a competition policy investigation into more liberal access of clearing houses for listed derivatives, balanced against whether open access could be safely applied.

Capital city: London looks set to retain its position as Europe's financial centre Getty

> 'The balance between safety and competition is being defined in individual items of legislation'

In such a complex world London looks set to retain its position as Europe's financial capital, even though reform of the OTC derivatives market strikes at one of its biggest businesses.

"Clearing naturally gravitates to the region in which the assets and liabilities exist," says Mr Ibbotson.

The form of that market remains the subject of intense debate. Inter-dealer brokers have argued that customers turning to the OTC markets for specific needs will be hardest hit as standardised futures contracts will not meet all their requirements.

As the rules begin to take effect in the US, innovation is beginning to come to the fore.

CME Group and IntercontinentalExchange, the futures exchanges, are transitioning their cleared energy swaps to futures. ICE has licensed indices from Markit to begin exchange-traded credit derivatives, a market that used to be traded bilaterally. Those products could soon make their way across the Atlantic.

Collateral drive puts the focus on settlements

Securities

Consumer demand may force greater innovation, reports *Philip Stafford*

The regulatory push to safeguard the world's financial markets is being felt at the end of the trading cycle: securities settlement.

As a result, the world of central securities depositories (CSDs) is coming under pressure from banks keen to break into this closely guarded market.

Settlement is the final part of the post-trade process in securities deals, where delivery of a security is swapped for cash and the transaction is confirmed as final. The value of securities settled by the US's Depository Trust and Clearing Corporation alone in 2011 was $1,700tn.

The process functioned in the financial crisis, so relatively little of the regulatory clean-up operation has been aimed directly at the industry. Nevertheless, it could still face upheaval.

Global regulators have focused their attention on shoring up the balance sheets of banks and making post-trade services such as clearing houses key infrastructure of world markets.

The effect of legislation such as the US Dodd-Frank act, Basel III and the G20 requirements for mandatory central clearing of derivatives contracts, has left the financial services industry fearful of a shortage of collateral at a time when new capital rules make banks unwilling to lend. Estimates vary but additional collateral could top $1tn-$2tn globally. Banks and brokers have begun to use clearing to offset their risk but few institutional investors, such as pension funds, have.

Consequently a hunt is on for available assets and CSDs are often repositories of high-quality collateral. Last year a survey by Accenture and Deutsche Börse's Clearstream said the financial sector could save $4tn annually by making collateral management more efficient.

"Collateral optimisation will have a critical role in helping market participants meet the new requirements and as a result many more market participants, including CSDs, will try to become more involved in the provision of collateral management services," says Marianne Brown, chief executive of Omgeo, a post-trade services venture owned by DTCC and Thomson Reuters.

These requirements threaten to shake up CSDs, which are still primarily domestic institutions that work to process securities trades within national boundaries. Two CSDs – Clearstream and Euroclear Bank of Brussels – handle trades in international securities and some cross-border

> 'The average trade is shrinking and all the layers in the life cycle of a trade have cut fees'

transactions in domestic securities and have made a start in the global battle to attract the business of national securities depositories. This month Euroclear signed a deal with Russia's central securities depository, while in the past 18 months Clearstream has concluded deals in Brazil, South Africa and Australia.

This push for more collateral also opens up the market for global custodian banks, which often act as single access points for customers to a national CSD. They exploit their economies of scale to offer lower overall settlement costs. Some, such as Bank of New York Mellon and State Street, have indicated they might create their own CSDs to optimise collateral and reduce client costs.

Marianne Brown, chief executive of Omgeo

"The pressure is on the efficiencies in the process. The average trade is shrinking and all the layers in the life cycle of a trade have responded with fee cuts," said Reto Faber, Europe, Middle East and Africa head of direct clearing and custody at Citigroup.

This tension between commercial competition and open markets and systemic safety is particularly acute in Europe.

On one side, the European Central Bank is leading the industry's most ambitious structural project, known as Target2Securities (T2S). Its roots predate the financial crisis and it aims to harmonise cross-border processes, cutting transaction costs and making the region more competitive with the US, whose only settlement agency is the DTCC.

Currently CSDs in each European country carry out settlement, and charges for cross-border trades can be high. T2S, due to launch in June 2015, is designed to remove the role of so-called agent banks. Twenty four CSDs have signed up to the framework agreement, including almost all in the eurozone as well as six outside the euro area. The UK, Switzerland and Sweden will not bring their own currencies into the project.

This has been beset by delays and CSDs are worried about the commercial pressures.

First, the costs of the IT project are high – about €400m – and will require additional investment. Second, T2S may drain CSDs' existing revenues.

At the same time the European Commission is going further in its attempts to prevent a failure of one part or all of what it deems key securities markets infrastructure. Reforms proposed in March for more than 30 securities settlement systems in Europe, including Euroclear and Clearstream, would be to ringfence potentially risky banking activities from essential market services that underpin trading.

The proposal has drawn criticism over whether simply ringfencing activity legally will result in more safety in the system.

Yet the regulatory push and customer demands may force the settlement industry to innovate more. In July Euroclear said it would open up its collateral management system to the market. It holds more than €20tn in assets under custody, most of them consisting of higher-quality fixed income assets.

Prominent failures leave self-oversight in spotlight

Futures

The industry is keen to keep the current safeguards, writes *Gregory Meyer*

After an *annus horribilis*, the futures industry is trying to make scandal a thing of the past.

On October 31 2011 broker MF Global failed and left a $1.6bn hole in customer accounts. Then in July a smaller broker, Peregrine Financial Group, went bust after its founder acknowledged a massive fraud. Clients of both are still fighting to get their money back.

The twin collapses exposed as fallacy the belief that customer funds are safe with registered brokers. These deposits, known as margin, are a critical part of the structure of futures tied to markets from corn to stock indices, ensuring traders make good on losses.

The damage to futures markets is easy to see. Global trading volumes declined in the first half of the year, according to the US Futures Industry Association. As of August 31, customer deposits entrusted with brokers were down 13 per cent from a year earlier. Lawsuits are flying.

Now regulators, industry groups and traders are jockeying over how to repair the damage without making markets too costly or onerous to trade.

"We understand it is going to take time to regain public trust and we're committed to doing whatever it takes to restore confidence in the safeguards for customer funds," Walt Lukken, FIA chief executive, told lawmakers in August.

At MF Global, funds were diverted from customer accounts as the company scrambled to keep itself afloat during a "run on the bank", its bankruptcy trustee has said.

At Peregrine Financial, founder and chief executive Russell Wasendorf Sr has pleaded guilty to stealing more than $100m from customers. Authorities say he sustained the fraud by mailing forged bank statements to auditors at the National Futures Association (NFA), a regulator funded by the industry.

Unlike Peregrine, no one has been charged with a crime at MF Global. But in some ways the apparent lack of criminal intent makes the case more unsettling for the industry.

"Peregrine is a real outlier," says Philip McBride Johnson, a former chairman of the Commodity Futures Trading Commission (CFTC) and veteran derivatives lawyer. "I can see customers being more concerned about MF Global. If it was nothing more than a crisis in the back office, that could happen anywhere, even among people who are perfectly nice."

Regulators have pushed through reforms already, but other changes face an uncertain future. After the MF Global collapse the CFTC placed new limits on where brokers may invest excess customer funds.

From November, information about where futures brokers have invested customer funds and other financial details will be posted online. Another rule addresses so-called "excess" funds that brokers routinely add to margin deposits as a cushion to cover a default by a customer. The so-called Corzine rule, named after former MF Global chief executive Jon Corzine, requires top executives to sign off on big withdrawals from excess funds.

The Peregrine case was embarrassing for regulators because Mr Wasendorf, a high-profile figure in the futures world, said he had duped them for 20 years.

> 'There were a lot of red flags that should have been spotted and that were not'

"As the [Peregrine] case highlighted, there were a lot of red flags that should have been spotted and weren't," says Lauren Nelson of Attain Capital, an introducing broker that had assets frozen in the Peregrine bankruptcy.

Mr Wasendorf's scheme unravelled after the NFA switched to electronic rather than paper verification of customer accounts.

One pending rule would let regulators view customer accounts online without notifying brokers or their banks, a system meant to prevent another Peregrine-style fraud.

One change that has not been proposed is the end of the industry's model of self-oversight. The CFTC delegates front-line broker regulation to the NFA and CME Group, the exchange operator that was responsible for auditing MF Global.

In October the CFTC proposed raising standards for the way self-regulators examine brokers and that it be alerted sooner when a broker becomes distressed. But the government agency lacks the budget to audit brokers itself.

The industry wants to maintain self-regulation. Terry Duffy, CME executive chairman, said in written testimony in August: "We have very compelling incentives to ensure that our regulatory programmes operate effectively. We have established a robust set of safeguards designed to ensure these functions operate free from conflicts of interest or inappropriate influence."

Another idea that has not come to pass is the creation of an insurance fund to cover losses suffered if a broker collapses, as exists in US securities markets. NFA says it is committed to study the idea.

Bart Chilton, a CFTC commissioner, said in a speech in August that a fund protecting customer claims of up to $250,000 would "help remedy the present crisis of confidence in the futures markets in the wake of the fall of Peregrine Financial Group and MF Global". But industry executives say the securities insurance fund is an imperfect comparison.

Unlike stock markets, futures are dominated by large institutional traders whose positions often far exceed $250,000.

A year after MF Global, the futures market's future is still murky.

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