

Comment:

Two years since Lehman: what has changed for F&O?

The market shocks of autumn 2008 led to two turbulent years for futures and options markets. But while the headlines have been dominated by depressed volumes and regulatory upheaval, much has been changing underneath. **Mark Aarons**, chairman of **Actant**, argues that listed derivatives will grow steadily in volume, and that tomorrow's hyperfast markets will hold plenty of opportunities, even for smaller firms.

After near-uninterrupted double digit growth for almost as long as anyone can remember, since the end of 2008 global trading in futures and options has levelled off.

But this masks some interesting sub-trends. Futures trading, for example (especially in North America), has suffered worse than options trading. Whereas equities volumes have held up well, volumes in interest rate products have come under pressure. After the tumult of 2008 and the quick move to near-zero rates across the developed world, perhaps this was to be expected. And although starting from a relatively low base, there has been a dramatic surge of interest in trading currency products.

The fastest growing regions by far have been Asia Pacific and Latin America, more or less mirroring an equal slowdown in North America and Europe.

In a way, it would probably be more surprising if overall volumes had not stalled, after such breakneck growth and such paralysis of the whole credit infrastructure. Some major players ceased trading all together, while others substantially pared back capital allocated to trading.

Yet despite the temporary upsets, many of the growth themes that were apparent in the market two years ago continue unabated.

Rapid progress

The power of technological advance - both hardware and software - is a given, and has allowed for a continued drive towards zero latency trading solutions. In practice, this has led to exchanges, telecoms suppliers, software vendors and members focusing attention on and massively expanding use of colocation services.

Financial markets have always rewarded players with the best access to information and the fastest response times; what is new is that this is now measured in microseconds.

Inevitably, under such circumstances, very large parts of the trading process are automated beyond pure order entry and cancellation, and there seems to be something about this which is making regulators uncomfortable.

Will it lead to an outright ban or general speed restriction on high frequency trading? Probably not, but already the backlash is being felt in a suspension of flash order prioritisation, and investigations into how trading halts can be extended when market moves are considered extreme.

Meanwhile, the trading world awaits further ramifications from the 'flash crash' of this May. The interlinkage of different markets and products - particularly exchange-traded funds and derivatives - is widely felt to be at the

heart of what went wrong although there is growing evidence that the lopsided mechanics of some proprietary internal matching algorithms played a major part. The rise of internalization and the rules by which it engages with central Exchanges is likely to come into sharp focus in the next few years.

Regulators wade in

Another nervously anticipated change in the trading landscape that can be traced back to the meltdown of 2008 (but would have seemed almost unthinkable two years ago) is the mandated separation of certain proprietary trading activities away from investment banks and into affiliates.

It is assumed that most equity derivatives business will need to be hived off and, although many of the world's largest futures and options trading houses are already independent, such an outcome is bound to alter traffic flows at the major exchanges.

The drive to get bilaterally traded over the counter bargains on to centrally cleared platforms could also impact markets in dramatic, if difficult-to-predict ways.

On one hand, a significant increase in on-exchange business might lower bid-offer spreads and attract even more business... on the other, the requirement to expose more business to public scrutiny might actually reduce what is done now, and hence also the hedging of those trades on exchanges.

Sources of growth

But there are still many reasons to believe we are just experiencing a cyclical slowdown inside a broadly intact structural growth story.

First, as just mentioned, the growth baton has now passed to the major emerging economies, where the drivers for increased use of derivatives are still at a very early stage.

Second, in spite of the losses sustained by banks and others during the meltdown and the consensus that unwise derivatives positions were near the epicentre of what went wrong, the need to hedge all kinds of exposures - interest rate, currency, asset allocation etc - is not going to go away.

On the contrary, as fresh debates over future pensions and longevity liabilities demonstrate, the need to identify and parcel out risk to counterparties better placed to hold it is, if anything, getting stronger.

Third, although the rollout of broadband internet access has continued apace and online execution-only brokerage services are now widely available and fairly well used, there is still massive potential to make financial products more accessible to retail investors.

In the UK, for instance, the holding company of spread-betting firm IG Index already boasts a larger market capitalisation than the London Stock Exchange itself.

The continuing drive to allow individuals more control over their lifetime financial planning and the increasing popularity of low cost passive investing tools like ETFs will encourage growth of volumes in exchange-traded derivatives.

Exchanges under pressure

The competitive framework circumscribing the activity of market participants and the exchanges themselves has also moved on. Dark pools have continued to proliferate, particularly in cash equities, although there appears little appetite to extend this into derivatives trading.

At the same time, the market shares of the old exchanges, particularly in Europe, are still being eroded by upstarts like Chi-X and Bats.

One response has been to reinforce the migration towards charging on a maker-taker basis. This model effectively involves a cross-subsidy to liquidity providers, paid for by price takers. As such, it has strongly encouraged the proliferation of pure algo houses.

One very simple business model, for example, could involve just automatically injecting buy and sell orders at the same prices over time in order to receive exchange rebates.

Unsurprisingly, as trading in the underlyings have fragmented and become subject to more volatile micro-movements, so have the system requirements of derivative solutions become more exacting.

Fine focus

Ever smaller minimum tick sizes - such as the extension of classes subject to penny quotes in North America - have compounded the issue.

Software vendors have responded by building better, smarter and faster. Price quoters can now handle valuation externally. The ability to cache greeks for a wide range of possible underlying prices means a great load on the system can be released and response times speeded up dramatically.

But the demand to configure trading strategies that cross instruments, products and markets, calls for new architectures and new components.

This is a rapidly evolving field where proprietary systems compete against off-the-shelf products and where the life cycle of a trading strategy can sometimes be measured in days or hours.

This places a premium on the usability of the front end and the robustness of safety features. Ultimately, as users require more flexibility and speedier build and test times, responsibility for designing and fine-tuning trading strategies seems to be tipping back towards the trader on the desk and away from his technical support team.

Distinctions dissolve

All these trends continue to lead to a blurring of definitions between market-makers and market-takers. It is even possible to discern a point in time, likely not far away, when distinctions along these lines cease to be meaningful at all. A trader will offer liquidity via two way quotes where fee structures make this attractive, at the same time as combining algorithmic strategies that seek out and exploit known or suspected correlations.

While decent access to capital to support trading positions and keep up technology spend will continue to favour the larger operators in the short term, opportunities for less well capitalised players should open up, as the range of programmable trading events keeps expanding.