

Exchange Traded Derivatives – Post Apocalypse

It is just over two years since Mark Aarons, Chairman of Actant AG, wrote a piece for FOW to mark the company's 10th birthday. The purpose of the article was to explore the significant events that had shaped the development of options markets during the company's first decade. Now, in the aftermath of the 2008 banking crisis he takes another look at how the world of Exchange traded derivatives has picked itself up, dusted down and moved on in new, exciting and sometimes surprising ways.

Many of the growth themes identified two years ago continue unabated. 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, ISVs and members focusing attention on and massively expanding use of co-location 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/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 prioritization, and investigations into how trading halts can be extended where market moves are considered extreme. Meanwhile, the trading world awaits further ramifications from the 'flash crash' of this May, where the inter-linkage of different markets and products – particularly ETFs and derivatives – is widely felt to be at the heart of what went wrong.

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. Currently, it is assumed that most equity derivatives business will need to be hived off and, although many of the largest futures and options trading houses in the world are already independent, such an outcome will be bound to alter traffic flows at the major Exchanges. In similar vein, the drive to get bilaterally traded OTC bargains onto centrally cleared platforms has the potential to impact markets in dramatic if difficult to predict ways. On one hand, a significant marginal increase in on-Exchange business might disproportionately lower bid-offer spreads and attract even more business ...on the other, the requirement to expose more business to public scrutiny could pare back what is presently being done and lead to a consequent reduction in on-Exchange re-hedging activity.

An overview of what has taken place in volume terms at the major derivatives Exchanges over the past couple of years reveals a mixed picture. At the very highest level, it's possible to say that after near uninterrupted double digit growth for almost as long as anyone can remember, global trading in futures and options since the end of 2008 has basically leveled off. But this masks a number of interesting sub-trends. Futures trading, for example (and especially in N America), has suffered relative to options trading and, whereas equities volumes have held up well, volumes in interest rate products have clearly 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, it's also clear that 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 and these more or less mirror an equal slowdown in N America and Europe.

In a way, it would probably be more surprising if volumes had not, in aggregate, stalled after such breakneck growth and such paralysis of the whole credit infrastructure. Some major players ceased trading altogether, others substantially pared back capital allocated to trading. But there are still many reasons to believe we are just witnessing 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 usage of derivative products are still 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 for hedging of all types of exposures - interest rate, currency, asset allocation etc. - is not going to go away. On the contrary, and as fresh debates over future pensions and longevity liabilities clearly demonstrate, the need to identify and then mitigate risk amongst better-placed counterparties is, if anything, getting stronger. Third, although roll out of broadband 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 the retail community. In the UK, for instance, the holding company of spread-betters 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 provide a strong backdrop for ongoing trend growth of volumes in on-Exchange derivatives.

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 the cash equities space, although there appears little appetite to extend this model into trading of derivatives. At the same time, market share of the 'old' Exchanges, particularly in Europe, is 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 and as such 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 underlying has fragmented and become subject to more volatile micro-movements, so have the system requirements of derivative solutions become more exacting. Ever smaller minimum tick size movements (e.g. extension of classes subject to penny quotes in N America) have just served to compound the issue.

ISVs, including Actant, have responded by building better, smarter and faster. In Actant's case, 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 (underlyings and their derivatives), products and markets, calls for new architectures and new components. This is a rapidly evolving space 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. These are the kinds of requirements that Actant's new ExStream product are designed to accommodate.

All of these trends continue to lead to a blurring in the definitional line 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. Whilst 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.