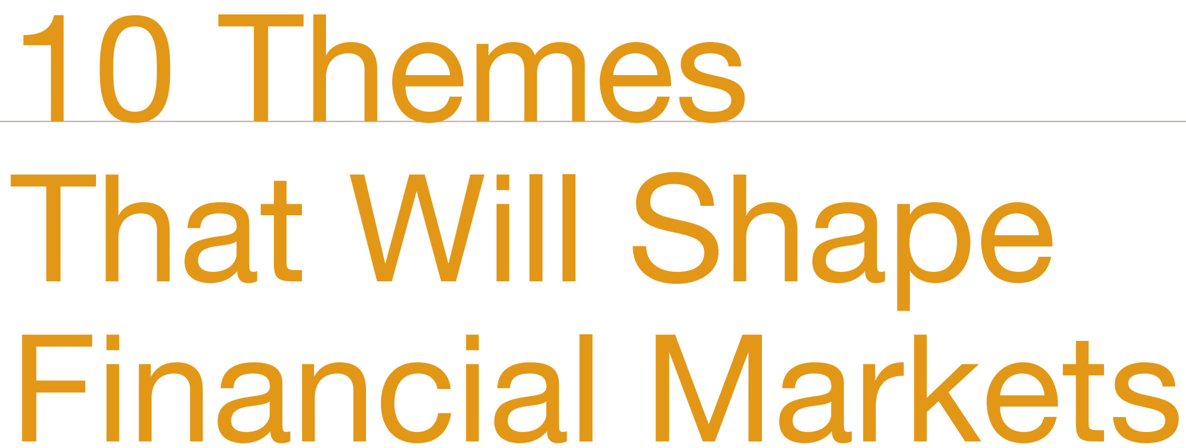


10 Themes That Will Shape Financial Markets

By Jane Gladstone

TO PROVIDE SOME thought-provoking insights on the future of the derivatives industry, FIA invited Jane Gladstone, an investment banker who has advised many of the leading companies in this sector, to speak at the exchange leaders breakfast at FIA's International Futures Industry Conference in Boca Raton, Fla. this past March. In her remarks that day, she outlined 10 themes that will dramatically impact the global financial markets.

Three months later, we asked her if she would be willing to let us publish her remarks. Although much has happened since then, these 10 themes are still relevant. Indeed, she said recent events have only strengthened her conviction.

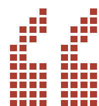
The trust deficit she discussed in Boca, for example, has only grown with the publication of *Flash Boys* and the many negative headlines and investigations probing high-frequency trading activity and payment for order flow. Her thesis that we are at the dawn of the era of "cyber weapons of mass destruction" has been amply supported by recent headlines about new threats, such as the discovery of the so-called Heartbleed bug. And SEF volumes still look like something out of *Gulliver's Travels*.

Most importantly, she stands by her view that exchanges have a critical role to play in restoring trust and making the markets safer, more efficient and fairer. As she said in Boca, if they can accomplish this, they will pay a huge special dividend to the global capital markets.

Thank you for this opportunity to speak at the exchange leaders breakfast. The exchanges gathered here today represent about $150 billion of market cap. That's a stunning number when I think back to when I first came to this conference in 2002. CME would go public later that year with a market value of only $1.2 billion. But more impressive than your market value is that you sit at the center of the greatest changes in the financial markets that any of us alive today has witnessed. We can all agree that the implications of these grand experiments in regulation, quantitative easing, tapering, capital requirements and the Internet are far from certain. So this gives me free rein to stir things up today with 10 themes that I believe will shape the global financial markets.

The incredible shrinking dealer

Basel 3's Supplemental Leverage Ratios make even cash deposits cost five cents of capital for every dollar of cash. Repo, agency securities and sovereign debt will also see their capital requirements increase, by two times or more. Perversely, those with lower risk assets are hurt the most, and market making in these lower risk assets, even U.S. Treasuries, is unlikely to generate minimum levels of return on capital. These new rules are likely to hit prime brokerage, the repo, agency and government bond markets hard. These new rules are being deployed in the midst of what we believe is a bubble in the fixed income markets, which could exacerbate their impact if this bubble bursts. Current high yield market pricing is better than during 98% of the past 18 years and the majority of volumes are now covenant lite. Dealer inventories are at the lowest level in a decade while notional U.S. bond market debt outstanding has approximately doubled. The effect of this has not been tested as credit mutual fund and ETF assets have seen about $700 billion of inflows during the last decade. If inflows turn to outflows we will test the impact of the incredible shrinking dealer.



The return of the non-bank broker-dealer

The absence of any major non-bank broker-dealers is an accidental consequence of the financial crisis which saw the five big non-bank broker-dealers go out of business or get merged into other banks, or convert themselves into bank holding companies during 2008. High frequency trading firms have already become the new dealers, often making tighter markets than their capital-intensive counterparts, and employing some of the best minds in technology, math, finance and physics. Several banks have also put their commodities business on the block and the buyers are expected to be non-banks. The Volcker rule also gives an advantage to non-BHC players. In the future, liquidity will have to come from non-bank broker dealers who now have a significant capital advantage and increasingly a technology advantage over bank holding companies. But banks will continue to be relevant.

The introducing broker will play an important role for years to come

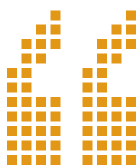
Bloomberg now represents 80% of dealer-to-customer trading in the swaps arena. Direct access by the buy-side is already significant and growing, so it is fair to ask what the future role of the dealer will be. But we hold these truths to be self-evident: the buy-side doesn't like to pay hard dollars for anything, it is already stretched thin with new compliance burdens and market complexity and uncertainty, and it lacks the scale of the sell-side. Let's face it: we might all be dead before investors can pre-allocate trades, so the standby clearing offered by the broker-dealers will probably continue to play an important role. Smart banks will offer straight through processing as this will trump anyone offering only pre-trade, trade, or post trade, or compliance or risk management services. UBS's launch last year of its Neo upgrade to its own single dealer platform is an example of this – multi asset class, global, around the clock, across lit and dark markets, multi dealer RFQ and CLOB, covering the full trade lifecycle and content enriched. It unites 94 systems into one. This model has the potential to replicate the low risk-weighted-asset/high-return model of FX across other asset classes. Credit Suisse also recently announced an electronic market making effort that brings an agency-style model to client flow in credit trading.

The golden days of the single dealer platform in FX and fixed income are probably over

360T, EBS Direct, Bloomberg, Integral and others have changed the role of the single dealer platform. According to the latest data from the Bank of England, single dealer platforms in FX represented the same volume as multi-dealer platforms, down from 2.5x the MDP volume five years earlier. Now that the market has gone electronic and data availability has brought transparency to markets, the single dealer platform has lost ground to independent platforms. We saw this happen first in the equities markets, where even some of the stronger platforms like Goldman's Redi and Lehman's Realtick threw in the towel in favor of independent or multi-dealer platforms. The FX fixing scandal also accelerated adoption of multi dealer models.

A new era of "jurisdiction shopping"

Remember how fast Eurex stole the Bund from Liffe? Electronic markets have radically increased the ability of capital to change jurisdictions. Market participants will go jurisdiction shopping and the cost of moving, and the speed with which they can do so, has never made it easier. Asian regulators don't appear to be following the U.S. or Europe. ICE's purchase of the Singapore Mercantile Exchange positions it to serve its customers in any major jurisdiction or time zone. CME has long had a relationship with Singapore Exchange. And Deutsche Boerse has significantly expanded its clearing operations and product offering in the region.



Some of the most successful venture capitalists have poured about $250 million into Bitcoin-related startups and Bitcoin has more developer mindshare than PayPal.

Being the leading SEF is like being the tallest Lilliputian, for now

Let's face it, SEF transaction volume is miniscule. What author of Dodd-Frank would have predicted that when trading on SEFs became mandatory volumes would decline?! Confusion and uncertainty over the SEF rules, lack of buy-side preparedness, a move offshore of some activity, and competition from swap futures can all be blamed to differing degrees. Clearly the lower margin, block trade size and clarity of rules in the futures environment give futures a real advantage over swaps. However, since swap futures volumes too have been disappointing, it is hard to blame much of this on futurization. It would appear that a bigger constraint than futurization is entrenched behavior – old habits die hard. Regulatory uncertainty both in domestic markets but also where cross border activities are concerned has also constrained transaction activity. So the vast majority of swaps volumes continue to be dealer-to-dealer and voice-brokered by interdealer brokers. Antiquated technology is under stress as the world slowly shifts to digital – new infrastructure is needed to grow volumes from here. Innovations in straight through processing and pre and post-trade capabilities will be vital to fulfill the goals of Dodd-Frank and restore liquidity to the swaps market. In the short term swap clearing costs could increase restraining volumes further. Longer term, technology innovations will upgrade antiquated systems, regulators will provide clarity, buy-side accounts will get connected to marketplaces, and volumes will grow. When volumes do recover, there may still be a question of how you make money just being a SEF. Trading on the Bloomberg SEF is virtually free. Even if volumes grow considerably from here, as I believe they will, execution revenues are likely to be dwarfed by clearing and other post trade services and by collateral management and other pre-trade services revenues.

Dawn of the age of cyber weapons of mass destruction

I am concerned that detection is not keeping pace with malware proliferation and defenses are finding it hard to keep pace with the growing cyber threat. Target did not spot its own breach despite malware being present in its system for weeks. Governments have got into the business. Iranian government-sponsored cyber terrorism is responsible for taking down the online banking sites of J.P. Morgan, Wells Fargo, Citi and Bank of America Merrill Lynch. So-called hacktivists seeking to punish Saudi Aramco, the supplier of 10% of the world's oil for "crimes and atrocities" in Syria and Bahrain, wiped clean 30,000 or 75% of the company's computers. Last year hacktivists put out a false tweet from an Associated Press account saying there had been an attack on the White House and the President was injured, causing a $136.5 billion decline in the value of the S&P 500 and a similar percent off the Dow Jones Industrial Average. China, Russia and possibly soon Iran will hold veritable cyber weapons of mass destruction. Will foreign policy in Syria and Crimea cause a cyber attack that shuts down our markets or brings down our banks? We should also expect greater regulatory scrutiny and more intense examinations focused on the industry's cyber defenses. Fines are likely to be levied on those organizations that don't do enough to protect customers –Target may test this theory soon.

The Internet of money is born

The Internet allows customized markets to operate where regulatory constraints do not inhibit them. So it facilitates a new market structure – neither CLOB nor RFQ nor dark pool. We call it the "customized CLOB," where individual users can choose their own rules and counterparties. But the Internet's impact may go well beyond market structure. Governments have already been toppled with the help of Twitter and Facebook. As Google's Eric Schmidt counseled governments afraid of popular uprising, "You can't turn off the Web." Even the Chinese government, the single most effective organization at censoring the Internet, can't do more than constrain activities. Bitcoin has been banned for use by financial institutions in China but citizens and merchants are allowed to use it and indeed Shanghai-based BTC is one of the world's largest Bitcoin exchanges. Math-based currencies with open protocols can't be abolished any more than the Internet can. Some of the most successful venture capitalists have poured about $250 million into Bitcoin-related startups and Bitcoin has more developer mindshare than Paypal.

The global financial markets are running a major trust deficit but market infrastructure providers are well positioned to fix this

The Libor and FX scandals, the demise of Bear Stearns, Lehman, Refoc, MF Global, PFG Best, the Knight trading loss, Not So Fabulous Fab, the metal warehouse controversy, the venerable Bank of England's suspension of an employee accused of FX market manipulation and soon the Michael Lewis *Flash Boys* exposé on the HFT industry. Our markets are not broken but Main Street believes that they are. The cost to the markets is unprecedented amounts of capital sitting on the sidelines and the increasing popularity of stores of value that are outside the financial markets. Real estate, art, gold, wine, Bitcoin. Today, there is $8.5 billion of Bitcoin outstanding which we believe has become, like gold, a proxy for the perceived value of disaster insurance. Both Bernanke and Yellen testified that they don't pretend to understand the price of gold yet it has outperformed all other currencies in the last six, 10 and 20 years. The historic devaluations of the Venezuelan Bolivar, the Argentine Peso, the Russian Ruble, and arguably the Japanese Yen, has called into question the value of fiat currency versus other stores of value. The

recent HanMag debacle in South Korea is disturbing for the failure to trigger an effective kill switch, the lack of unwind authority for clearly erroneous trades, and the Korean clearinghouse dipping into default funds from non-defaulting members, and that with no skin lost in the game. Exchanges have a critical role to play in restoring trust in global capital markets. Benchmark administration, new kill switch technologies and clearinghouse risk management and waterfalls are all important examples of exchanges providing much needed infrastructure to make the markets safer. The financial crisis saw the burden of saving financial institutions fall on taxpayers and lack of transparency in the OTC markets make defaults contagious. In response to this regulators have sought a better way to mutualize risk in clearinghouses and shed light on OTC markets. The shortcomings of regulation are well known, but long term this audience is working to make the markets safer, more efficient and fairer. Accomplish this and you will pay a huge special dividend to the global capital markets.

M&A – Never engage in static analysis

What do I mean by "never engage in static analysis?" There is a danger in thinking that the world you know today will be the world we live in tomorrow. All the components are there to create a dynamic M&A environment. First of all this should be a good year for business. All those hours spent with lawyers pouring over footnotes can now be redirected toward growing the business. It finally feels the economy is out of the woods. Major U.S. stock market indices were up 27%-38% last year. Quantitative Easing is beginning to taper. But you say "Are there any big deals left that can and will get done?" Indeed, 2011 was "the year of exchange mergers that weren't, as one by one flag issues and antitrust authorities blocked the big deals that were announced and attempted. However, the one thing I've learned dealing with mega mergers is one must mark to market one's views about what antitrust regulators will and won't allow, as well as how governments and market participants will come out on flag issues. I love to compare and contrast the reception that Nasdaq's attempt on NYSE got, as well as the second review that BATS takeover of Chi-X was subjected to, with the Direct Edge/BATS merger that just closed and did not even receive a second look from antitrust authorities. And no doubt millions of dollars were flushed down the toilet arguing that if antitrust authorities let CME/CBOT go through they must allow Deutsche Boerse/NYSE Euronext. Contrast the indifference that met the potential sale of the NYSE to the Germans with the rallying cry of the Canadian banks who put together the Maple consortium or the Australian government concluding that the SGX deal was not in their country's national interest. I believe that 20 years ago the United States would have responded similarly to Canada and Australia. So don't jump to conclude that a particular deal can or can't happen – the answers will be very fact and time specific. However, as a practical matter there are less than a handful of mega mergers left in the exchange sector; the greater number of deals are likely to come outside the execution and clearing space in the areas of pre-trade, post trade and data and within certain OTC asset classes that are undergoing dramatic change, such as FX and fixed income. Your competitors today may be very different than tomorrow and this, as always, will make for a very interesting M&A landscape.

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