PROP TRADING SPECIAL REPORT

FOW SUPPLEMENT First Quarter 2015

PROP IDOL: THE BEST OF LONDON'S PROP TRADING COMMUNITY JOIN TO DEBATE THE FUTURE OF THE INDUSTRY

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PROP TRADING IN AN ELECTRONIC WORLD

COST, TECHNOLOGY AND ADAPTABILITY REMAIN KEY TO PROP TRADERS' OPERATIONS IN THE MODERN TRADING LANDSCAPE WRITES ALICE ATTWOOD.

Proprietary trading has evolved over recent years as market participants have been forced to come to terms with cost pressures, impending regulatory changes and the still-increasing adoption of electronic trading. But what have these requirements meant for proprietary trading as a whole, and what's next for this unique market?

COST

The trading lifecycle presents many real cost pressures for firms, from mandatory clearing and trade reporting to legal needs and paying the traders themselves.

But the advent of electronic trading and its monopolisation of the market has forced firms to dramatically increase their technology spending if they want to remain competitive.

Beyond technology requirements, prop traders are facing other cost challenges. Often such firms rely on one revenue stream - trading - so when trading margins are squeezed, the affect can be seen across the business. At such times, costs must be passed on to clients, which has the potential to hurt ongoing business and deter potential new clients.

The uncertain regulatory environment also represents a cost pressure. Impending regulation means that firms cannot wholly prepare for regulatory changes.

> "Point and click trading also makes sense in extremely volatile markets - such as 'Flash Crash scenarios - where every order entering the market needs a manual check before the order is released into the market"
>
> **Howard Tai, Aite Group**

HOWARD TAI, AITE GROUP

Regulation uncertainty weighs heavy on prop trading firms, with the cost of this preparedness seen across company's technology, compliance, staff and research divisions.

Higher scrutiny of costs is not a problem for the prop trading community alone, though, with the European Markets Infrastructure Regulation's (Emir) prospect of higher swap clearing costs for asset managers recently sparking interest in alternatives. The FX market is also still awaiting clarity on the clearing mandate for non-deliverable-forward (NDFs) contracts.

EVOLUTION

So what is the result of these cost pressures? Despite simply making it harder to make money and remain profitable, increased associated costs have led to some firms shifting their consumption of news, data and analytics to free internet-based resources, such as TweetDeck.

Traditionally, a prop firm's IT was exactly that, proprietary. Traditionally it was built, designed and assembled by them and for them, said BT's global head of strategy and business development, financial technology services, Alexandra Foster. "As the business needs and the market has changed, so have the providers of systems and software that can be used by prop houses. The provider model is more agile, more flexible, and more software-as-a-service based, so has grown in appeal amongst the prop trading firms."

While technology spend remains a big factor, what this means for companies varies depending on whether they manage IT inhouse or outsource, each of which comes with their own challenges and cost requirements.

Foster notes that the compute-on-demand and hosting space is seeing a change here; prop houses can turn to technology providers for outsourced technology infrastructure, as well as being able to select other service providers in the trade life cycle, such as prop house clearers, presenting firms with further opportunities and ideas for their technological needs.

Howard Tai, senior analyst at Aite Group, told FOW the seeming rise and rise of electronic trading (see chart) has resulted in a new type of prop trader, perhaps with non-trading trading backgrounds, such as mathematicians or computer programming.

This sentiment was echoed by a panel of some of London's key players in the proprietary trading industry at an FOW roundtable event held in January (see page XX for a full write-up of the event.)

The panellists suggested that the required attributes for prop traders today go far beyond the characteristics of a 'traditional trader,' with flexibility and adaptability traits for new hires and a coding or more technical background seen as an advantage.

Beyond just technological advances, which have undoubtedly boosted intelligent capabilities, regulation has been an important driver in the changing trading environment we know today.

"The increasing use of computerised trading - driven by the move from "open outcry" - and the growing use of electronic trading platforms has in theory created an environment where larger trading volumes can be traded at lower cost across multiple assets," Foster told FOW.

"Regulatory changes have played a huge role in the development of electronic trading. From Dodd-Frank, Emir to Mifid II, regulations are in place which require financial services institutions to Read, Record, Retain, Restore, Retrieve, Replay, Recite, Recreate and Reconstruct — all of which need to be done Reliably! We are talking 'R's to the nth degree, and all of these 'R's are in place for one reason — to mitigate Risk," she added.

Aite's Tai said the adoption of smart order routing and the proliferation of algorithmic trading paved the way for a new prop trading style - High Frequency Trading – which remains prevalent in the space.

POINT AND CLICK

While the market has seen, and benefited from, innovation and evolution to a more electronically-reliant sector, it is debatable if there is still a place for point and click trading in the modern market.

Aite's Tai suggests that for institutional and prop traders in thinly traded securities and instrument types across assets, this opportunity remains, and can be adopted for small lot and retail-oriented traders in liquid markets.

"Point and click trading also makes sense in extremely volatile markets - such as 'Flash Crash scenarios - where every order entering the market needs a manual check before the order is released into the market," he said.

Foster takes a more cautious approach when it comes to the relevance of point and click in the modern trading landscape. "It depends on what your strategy is. Even with the electronification of the market, there are some situations where regulators have put in caps and barriers up… for example, HFT's style trading. In that scenario, a human trader or click to trade with a low order to trade ratio could have a place. But not all strategies have a need for HFT style, so point and click trading could surface."

COMPLIANCE

The growth of e-trading creates opportunities and obligations, not least pushing compliance technology provision up the agenda.

A robust compliance system was once perceived by market participants as a "nice to have," but now it is undoubtedly a competitive differentiator for both brokers and execution venues.

Research firm Aite predicts company spend on compliance technology will reach $441m (£280m) in 2015, up from the $375m in 2013, an 18% increase over the two years, driven largely by the evolving electronic trading market.

The firm said much of the compliance spending currently comes from brokers but expects this to change, with more likely come from trading platforms, particularly those offering over-the-counter products.

The overall adoption of electronic trading has evolved well beyond just point-


ALEXANDRA FOSTER, BT

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and-click trading and into the automated trading world, demonstrated by growth in algorithmic trading adoption across different asset classes. "We have seen strong adoption of e-trading in both options and futures markets," Danielle Tierney, senior analyst at Aite told FOW in December.

DEVELOPMENTS AND OPPORTUNITIES

Looking ahead, Tai suggested the market may see some reduction or even the elimination of certain predatory order types being routed electronically in the marketplace, potentially paving the way to a market that provides a more level playing field to all types of players.

Research consultancy GreySpark Partners' study 'Trends in FX Trading 2014' predicted that a long-running trend of product consolidation in the FX options instrument class could lead to a more electronic future for hedging tools.

BT's Foster also predicts a number of opportunities in the space: "The need to be able to record, restore, replay and reconstruct a trade based on decisions by algos/machines is creating a wealth of big data and trade surveillance opportunities. Data is becoming a genuine asset. Here analytics tools can come into force allowing retrospective, real time and forward looking analysis of data."

WHAT'S NEXT?

Electronic trading is now recognised as an inherent part of the proprietary trading market and with costs rising at the same time as volumes in some markets are declining, the importance of prop trading continues to gather pace, especially as banks scale back their market-making and prop trading operations.

The evolution of the market has ultimately led to the changes in company requirements for traders with 'e-savviness' generally accepted by and expected of new traders joining the market.

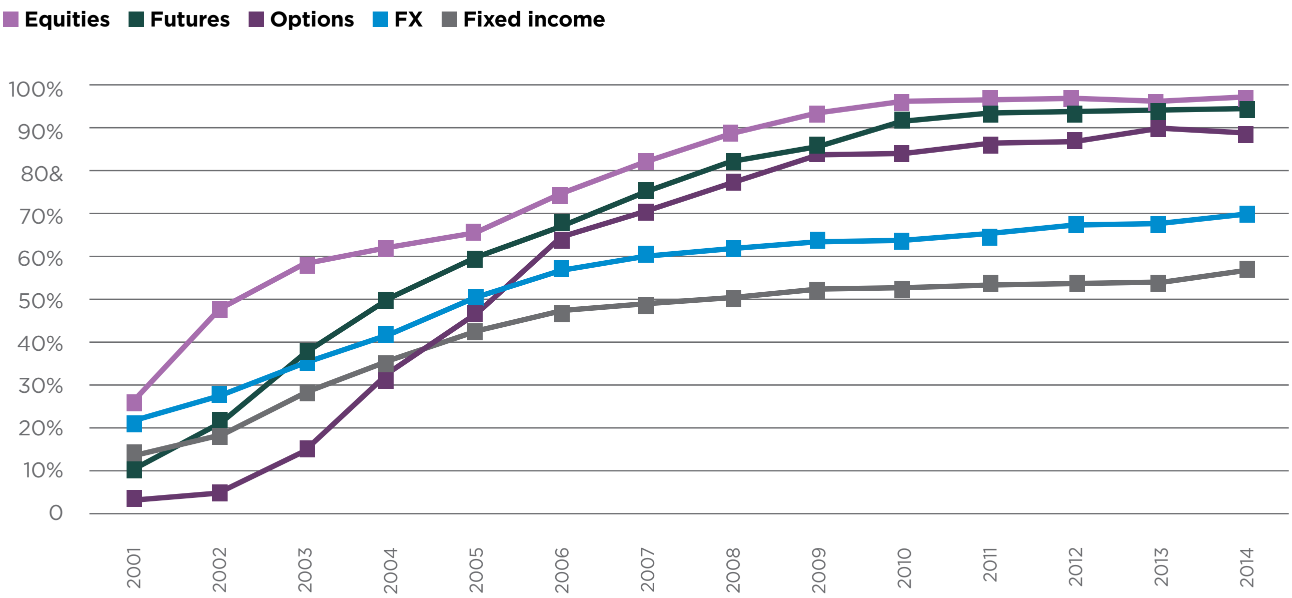
This means more experienced traders are having to adapt to increased regulatory and working environments, and this can be tough for traditional traders that earn their stripes in a very different market, leading to a change in the stereotypical characteristics of a prop trader.

The result of this could be two-fold; a wave of new technology-focused market participants or a mass exodus of experienced floor traders leaving the market in disgust. The adage of 'adapt or die' may cruelly be charted against the rise and rise of e-trading.

And this electronic reliance shows no sign of slowing, Foster told FOW. She expects the adoption of trading technology to only increase, "as an effective solution to meet the associated challenges. I especially see an increased uptake in cloud and managed services."

"And I see the growing appreciation of data as an asset. The idea of a seamlessly integrated approach to processing, managing, delivering and correlating data has the potential to change not only the technology landscape but, more importantly, the business landscape as well," said Foster.

ADOPTION OF ELECTRONIC TRADING 2001-2014 • Source: Aite Group Estimates



MIFID AND PROP TRADING

IN THE POST FINANCIAL CRISIS WORLD, THE INDUSTRY IS STRUGGLING WITH THE INCREASED DEMANDS OF NEW AND MORE STRINGENT REGULATIONS. FIRMS IN THE US HAVE HAD TO GRAPPLE WITH THE IMPLEMENTATION OF DODD-FRANK AND MANDATORY CLEARING AND RECENTLY EUROPE HAS SEEN EMIR AND NOW MIFID II. WRITES CIAN BURKE.

Since the introduction of Emir in 2012 the industry has had to come to terms with increased capital requirements, trade reporting, mandatory clearing and the costs associated with the armies of compliance staff now required. But with the publication of the final draft of the Mifid II in December financial institutions of all sizes have been scrambling to come to terms with the new wide-ranging rules and how they will affect their businesses.

Proprietary trading firms are no exception and they are faced with a number of challenges within the Mifid text.

Being classified as a DEA user under Article 2(1)(d)(ii) of Mifid II could have had serious consequences for prop traders and other end users. They would have needed to be authorised as an investment firm and fall under the requirements of Mifid II, Mifir and the Capital Requirements Regulation.

In effect the DEA user would become a financial counterparty as defined by Emir and would be subject to tougher obligations including mandatory clearing and collateralisation.

In what will come as a relief to prop traders and the industry as a whole the European Securities and Markets Association (Esma) has decided to exclude algorithms known as Smart Order Routers (SORs) from its definition of DEA.

SORs are algorithms used by most exchange members to achieve best execution of trades by determining which venues to use and the best time to submit the orders.

According to Esma's newly published technical advice on Mifid II "if SORs are not embedded in the client's order generating system, but in the market member's/participant's own routing system, it is considered to be out of the scope of DEA, as the client of the market member has lost control over the time of submission of the order and its lifetime".

Esma's technical advice stresses that only market participants with exact fraction of a second control over order entry and lifetime will be considered DEA users.

While Esma's decision to exclude SORs is seen as a sensible step by the market participants, it has not resolved the so-called 'exemption from the exemption' rule.

The rule contained in the revised Article 2(1)(d) MiFID II now pulls back in certain prop trading firms that otherwise would not have required authorisation.

Non-EU firms are supposedly outside the scope of Mifid II but it is believed that the DEA provisions could over-ride this exemption. In essence non-EU firms trading under a DEA agreement with a European broker would need to be regulated under Mifid II to continue to trade under the arrangement. Along with the other onerous obligations being regulated under Mifid II, this would require a physical presence in Europe.

In addition Article 48(7) Mifid II now requires DEA providers to be authorised, which will have an effect on US intermediaries.

Nathaniel Lalone, partner at international law firm KattenMuchinRosenman, explains US intermediaries "may want to benefit from the so-called "third country passport" under the Mifid II/Mifir regime,

> "There is a risk that an equivalence determination could be held up because the US has no equivalent to the "exemption from the exemption" under Article 2(1)(d) Mifid for own-account derivatives traders, and in theory non-equivalence in any one area could hold up the entire equivalence determination"
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> **Nathaniel Lalone, KattenMuchinRosenman**

NATHANIEL LALONE, KATTENMUCHINROSENMAN

MIFID MAIN CHANGES

TRANSPARENCY

Pre-trade transparency for non-equity
Trading venues will need to make information about trading interest publicly available. This obligation will not apply where there is not a liquid market for an instrument, an order is large-in-scale compared with normal market size, is held in an order management facility or is trading interest above a size that that would expose liquidity providers to undue risk

Non-equity post-trade transparency
Details of transactions conducted on trading venues will need to be made public as close to real-time as possible. Deferred publication will be possible for under certain circumstances including when a transaction is large in scale compared to normal market size.

COMMODITY DERIVATIVES

Exemptions
The current broad exemptions for commercial firms who trade commodity derivatives are being narrowed. In future such firms will only be exempt where their activity is 'ancillary' to their main business and their main business is not financial services.

POSITION REPORTING

Details of positions will need to be reported to trading venues on a daily basis. Once a week this information will need to be sent by the trading venues to the European Securities and Markets Authority (ESMA) who will publish aggregated reports distinguishing between positions held by commercial firms and financial firms.

MARKET STRUCTURE

Organised Trading Facilities
OTFs will only be able to trade non-equity instruments. They will be able to exercise discretion in order execution, such as playing a role in negotiations between market participants. OTF operators will be able to trade on a proprietary basis on their own platform in illiquid sovereign bonds and trade on a matched principal basis in all bonds.

Derivatives trading obligation
Transactions in derivatives subject to the clearing obligation under EMIR will be required to take place on an RM, MTF or OTF where the instrument is sufficiently liquid.

TRADE REPORTING

Consolidated tape
Will come into effect for securities from January 2013. Two years later it is envisaged that there will be a consolidated tape for non-equity instruments. The consolidated tape will be available free of charge 15 minutes after publication


ROB MOULTON, ASHURST

however this requires an equivalence determination by the EC".

"There is a risk that an equivalence determination could be held up because the US has no equivalent to the "exemption from the exemption" under Article 2(1)(d) Mifid for own-account derivatives traders, and in theory non-equivalence in any one area could hold up the entire equivalence determination".

The exclusion of SORs from the definition is not the only change to Mifid II that's likely to affect traders leveraging DEA. Esma's decision to drop requirements for DEA providers to analyse their clients' algorithms will come as a relief for algorithm traders.

Under article 24, DEA due diligence requirements, DEA providers must instead be aware "of the types of strategies to be undertaken by the DEA user".

Mandatory exchange algorithm conformance testing is now only required for members, participants and sponsored access clients.

While DEA users' algorithms will not be subject to formal conformance testing, they will be required to conduct self-assessments. Under Article 2, DEA users must now be registered under and subject to the requirements of Mifid II, Mifir and Capital Requirements Regulation. As such firms will be subject to a self-review set out on page 231 of the consultation paper Annex B.

Esma has set out a list of 37 different items that a firm must gather before DEA can be provided.

This document requires annual review and includes items such as testing, risk, controls, governance, accountability, sign-off framework and business continuity planning. It must have sign-off from an independent audit and risk function as well as senior management.

However, as is common with Mifid II, there is a degree of ambiguity surrounding Esma's proposals. Article 11 contains a clause that could see some DEA users algorithms subject to non-live testing (exchange testing). Article 11 stipulates: "Investment firms that are not accessing through a trading venue as a member or participant, but through DEA, shall make use of non-live testing environments where this is appropriate to the nature, scale and complexity of their business."

Rob Moulton, a partner at Ashurst, said: "Testing requirement is likely to catch those whose use of DEA is sufficiently large that their trading could cause an issue if something went wrong."

"Some firms use DEA infrequently and might fall below this threshold, but those using automated trading methods are likely to have to accept that automation brings with it risks that require testing."

Accurate and up-to-date market data is a fundamental prerequisite for any trader hoping to make informed decisions. Exchanges and third party providers have been charging for access to this vital commodity for decades.

Every prop trader is no doubt aware the significant costs associated with market data but they probably won't be aware that Mifid II will affect the amount they'll pay in the future.

Esma plans to restrict the fees exchanges and data vendors charge for market data in a move to make information more affordable for trading firms. Proposals in articles 64(1) and 65(1) of the latest draft of Mifid II suggest exchanges must provide market data on "reasonable commercial basis".

Esma's technical advice contains a number of proposed tools that could reduce market data fees for all user groups.

Data providers will now be forced to offer pre-trade and post-trade data separately as per articles 12 and 13 of the Mifid regulation.

Trading venues will also be obliged to offer price per user licenses, in effect requiring all venues to offer a user-based unit–of-count pricing model already offered by some exchanges. The model allows clients to net part of the market data costs from a single source across data vendors and across devices.

Esma said trading firms consuming data through a vendor are often charged based on the number of devices used, and, as a consequence, they are charged several times for the same data.

"Some firms use DEA infrequently and might fall below this threshold, but those using automated trading methods are likely to have to accept that automation brings with it risks that require testing"

Rob Moulton, Ashurst

MIFID TIMELINE

MAY TO AUGUST 2014	PUBLIC CONSULTATION ON DISCUSSION PAPER (RTS AND ITS)
MAY TO AUGUST 2014	PUBLIC CONSULTATION ON CONSULTATION PAPER (TECHNICAL ADVICE FOR DELEGATED ACTS)
7/8 JULY 2014	OPEN HEARINGS IN PARIS AUDIO 7 JULY AUDIO 8 JULY
DECEMBER 2014 TO MARCH 2015	PUBLIC CONSULTATION ON CONSULTATION PAPER (RTS AND ITS)
DECEMBER 2014	FINAL TECHNICAL ADVICE FOR DELEGATED ACTS SUBMITTED TO THE EUROPEAN COMMISSION
DECEMBER 2014	FINAL RTS ON CAPITAL REQUIREMENTS REGULATION (CRR)
FEBRUARY 2015	ADDITIONAL PUBLIC CONSULTATION COVERING CERTAIN DERIVATIVE CLASSES FOR NON-EQUITY TRANSPARENCY PURPOSES
19 FEBRUARY 2015	OPEN HEARING ON SECONDARY MARKETS AND INVESTOR PROTECTION
LATE SPRING/ EARLY SUMMER	PUBLIC CONSULTATION COVERING ITS AND ESMA GUIDELINES MANDATED IN MIFID II
JUNE 2015	FINAL RTS SUBMITTED TO THE EUROPEAN COMMISSION
DECEMBER 2015	FINAL ITS AND GUIDELINES SUBMITTED TO THE EUROPEAN COMMISSION
JANUARY 2017	MIFID II APPLIES IN PRACTICE

Prop Idols: The next generation talks cost, competition and opportunity

Prop trading firms have emerged out of the darkness in recent years to become vital liquidity sources. Some of Europe's top traders talk about the main challenges and opportunities for the industry going forward.

Luke Jeffs, Editor, FOW:
Prop trading has been a fixture of the futures and options markets for decades but the withdrawal of the banks from proprietary trading and the increased professionalism of the industry has shone the spotlight on the specialists but what are the main challenges they face today?

Mark Slade, Chief Rick Officer, OSTC:
The trend over the last few years is that costs have been going up in every area. In the clearing space, regulatory complexity increases costs for clearers that have to be passed on and that's why value adds like margin finance and effective collateral management have become more important because they reduce the capital burdens and enable us to continue growing our businesses.

Exchange fees have a direct effect and there are also "stealth taxes" coming in the form of data fees and other ways that exchanges can squeeze revenue out of the market.

And then we have our own cost base, which is being impacted by increased regulatory obligations. A lot of prop firms have had exemptions from Mifid and Mifid II but many of those are being taken away meaning the vast majority of us will have to be regulated under Mifid II. This again brings extra costs that have to be met from the same revenue pot.

So the burden of those extra costs means we have to try and make more money to stand still given the backdrop of the first six months of last year having the lowest volatility since 1970.

Most prop traders will say the second half of last year was better because of some global macro events. Energy saw big moves, fixed income started moving and the recent news of European Quantitative Easing and the Greek elections has caused some movement in European contracts. That's helped but it's only reducing the impact of all those other cost pressures.

Jeffs: What about technology costs?

Slade: It depends which space you're in. Some firms choose to join the latency sensitive race, others don't. Our judgement ten years ago was we will never be able to compete with the Getcos and the others, and so we said 'we're not going to play and compete in that space'.

So we haven't been hugely affected by the increased costs of trying to get lower latency. Fortunately for us, a lot of software vendors and clearers have provided infrastructure and grown with the demands of their customer bases and that's pulled us along with them, so we've benefitted without having to pay too much extra.

Robert Smith, Founder, Applied Financial Technology:
Go back 15 years and a common floor trading strategy was making two-sided markets. There was no technology advantage - everyone was standing in the pit.

But when you adapt that strategy to an electronic exchange, the costs escalate. At my former employer, we were co-locating before that was even a word! We

SPEAKER KEY

LJ:	Luke Jeffs, editor, FOW
SW:	Steven Woodyatt , chief executive, object trading
EK:	Eldon Kerr, director, Starmark
SH:	Stuart Heath, head of UK representative office, Eurex
RS:	Robert Smith, founder, Applied Financial Technology
DV:	Didier Voinchet, head of trading at Bullmoose Derivatives
MF:	Martin Frewer, global director, PTG, ABN Amro
MS:	Mark Slade, chief risk officer, OSTC


LUKE JEFFS


STEVEN WOODYATT


ELDON KERR


STUART HEATH

had conversations with exchanges about putting our servers in their data centres, and they said: "Oh that's a novel idea."

At the beginning, the costs were reasonable because the exchanges were just looking to cover their costs. Over time though, you see firms realise they can charge 800 bucks a rack.

It became increasingly expensive over the past decade and today if you want to employ a strategy that requires you to be first in the queue, the costs are astronomical. I don't see how small prop firms can compete with the same strategy.

Jeffs: So how you going to make your money then considering you are from a high investment, low latency background at Getco and you are now starting a smaller prop firm?

Smith: With a strategy that does not require me to be at the top of the book. Market-making firms take little risk. My former firm had a track record of earnings day-in and day-out and that was fuelled by the investment we made in the technology.

I have stepped back from that and taken a different view of how to manage risk and capital and employed a different set of systems and metrics that are profitable but in a different way.

Didier Voinchet, head of trading at Bullmoose Derivatives:
Firms like ours represent the new generation of traders. There has been more regulation over the last few years but that is good because the market needed it.

We needed to feel safer in the market. This is not always the case now but it is much better than it used to be. For example, there used to be a lot of price manipulation four or five years ago and it is not such a problem today.

But the big challenge is rising costs and this is serious because the trading population is shrinking and changing. Before we saw traders entering the market

aggressively and holding big positions but these trades are disappearing because it represents a big risk, for us and the clearers.

It is risk for a return that is not that big. It's a low margin business so ultimately we are taking a lot of risk for a small return.

Eldon Kerr, director, Starmark:
The basic problem is that you've got increased costs in the form of regulation, data, newsfeeds, co-location and exchange fees. These costs are going up but you also have a shrinking pie.

Prop traders have to make money in the markets and it's been increasingly difficult to do that. The main issue is the lower volatility, and when there is volatility it's this mad volatility which is difficult to trade.

The index providers now ask traders to pay to get the breakdown of the index they are trading. So if you're trading the FTSE, you can't find out the member weightings, the number of shares etc unless you pay and these are expensive items for individual traders.

> "Prop traders have to make money in the markets and it's been increasingly difficult to do that. The main issue is the lower volatility, and when there is volatility it's this mad volatility which is difficult to trade"
>
> Eldon Kerr, Starmark


ROBERT SMITH


DIDIER VOINCHET


MARTIN FREWER


MARK SLADE

> There's no Eurodollar contract comparable to the CME's so they can put their fees up as they have by two cents because there's no other place to go
>
> **Mark Slade, OSTC**

Traders have had to change the way they approach the market. If tools aren't available to them, they have to change the way they trade.

There were clearers that would provide margin financing but many have left the prop trading market or changed the financing they offer.

This makes it more expensive to trade cross-exchange spreads, even though the profit and loss risk is significantly lower. One solution is a change to outright trading, the preferable route is to find a group that can provide risk margin financing like Starmark.

The front end is a big cost for traders so they're looking for cheaper alternatives to their traditional providers. Some newsfeeds come with two year commitments to their services and that's daunting for a new trader or a prop trading group that has a trader that wants one of these newsfeeds.

People are starting to look at free internet-based alternatives such as tweet deck that aggregates the user's selected Twitter feeds.

At Starmark, we've always been technology oriented and we've invested in an intranet-based platform that enables us to reconcile with our clearer every morning on a sub-account level and provide a guesstimate of exchange margin requirements and an accurate value-at-risk number, all in real time. We also have an in-house front end providing access to the major futures exchanges at a lower cost.

We're mindful clearers are under cost pressures as well. Our objective is to try to make ourselves as easy to work with as possible.

We also ensure we have technology in place to provide paper trails for all our trades. I'm not sure what Mifid II will require but we see a growing need to have the data on why a trade was put into the market and what happened to that trade - to have the full story.

Jeffs: That's quite a lot for a firm to take on.

Kerr: It is and we funded that technology when times were good. We've been trading since '98 so there was a good ten years when you could justify spending on this sort of technology because it paid for itself.

Between 2009 and 2013 we spent less because we already had a lot of what we needed. Recently we've started to push our technology spend again because there's demand for the types of products we can deliver.

Jeffs: Martin perhaps it leads quite nicely into your world, I mean, is what you're hearing consistent with what your clients are saying?

Martin Frewer, global director, PTG, ABN Amro:
My perception of the ISV world is those costs are falling whereas other third party costs such as market data, datacentre and network costs have risen.

On a more macro level, Basel III and Capital Requirements Directive 4 will impinge on the General Clearing Members' cost bases as we move forward.

We are a service provider so we are transparent in our third party costs and pass on any benefits to our clients. Principal traders as a market segment are cost conscious.

One of the biggest increases in cost over the last two years has also been the avalanche of regulatory and compliance issues.

Like others we have had to employ market abuse systems and ensure that we are active in managing and controlling our clients trading processes.

Then there are costs associated with offering more opportunities to clients and we have to evaluate whether a new exchange is going to be a venue which will attract volumes.

Unfortunately, some of new exchanges that have been set up in Europe have not been successful which is a cost that we have to bare as any new exchange is a large investment for us because it has to go through strict levels of internal audit, development and strict risk validations.

Slade: We want to be able to trade these markets because they may be the next big thing. Liffe used to have a monopoly on short-end fixed income in Europe but without competition, fees go up.

There's no Eurodollar contract comparable to the CME's so they can put their fees up as they have by two cents because there's no other place to go.

Without competition, that will happen so we've got to try and support them otherwise there's no competition out there. Unfortunately that puts a huge pressure on the clearing firms.

Frewer: The migration of OTC products to exchanges has been slow and we hope it happens sooner rather than later.

In the meantime the new exchanges have been a cost to us, but we do anticipate added volume to be created by the migration of OTC products to being exchange-traded and centrally cleared.

Cost is always an issue. Another that we are facing is the implication of Basel III. Competing CCPs have meant that costs have remained relatively low but as GCMs, we have now have counterparty risk with those CCPs which means we have to make allowances in terms of risk-weighted assets. So even in the competitive landscape of CCPs -- although the end clients have benefitted, there is an additional burden of cost to the GCMs.

Increased concentration within the GCM community has also contributed to keeping clearing costs low. In the past there were 72 FCMs in the US and today you could say are realistically 14. There has been concentration and consolidation but that has reduced costs to the end customer.

Stuart Heath, head of UK representative office, Eurex: On costs, my general observation is when there's huge volumes going through and lots of volatility, the exchange fees tend not to be mentioned.

We haven't put our fees up and equally we haven't put our fees down. You could argue we started off relatively expensive, I don't know. But we run an exchange which is a marketplace. It's an infrastructure with a large set of fixed overheads -- to run the platforms, to run the trading systems or run the clearing system -- and they don't go away when volumes are down.

We also made investments in our trading platform and have already moved to a new system but clearing is where most of the latest investments were made.

Much of the costs are complying with regulation and fulfilling all the myriad requirements within the post-trade environment. We have to provide this before it can be provided by the GCMs to the customer in terms of the appropriate segregation of accounts that you need within Europe that has to be set up within the clearing house.

So the cost on the post-trade side is huge as well and I agree with Martin: we're hearing the GCM model is becoming a struggle and the costs are likely to be passed on sooner rather than later, it's a case of who is going to move first.

We're not immune to that. We realise that's a big issue.

Smith: I just want to pick up on the new exchange point. Depending on the infrastructure requirements of the prop trading firm, it's expensive for a firm to connect to a new exchange.

It's also expensive for a firm to keep up with the infrastructure changes on an exchange, it's a big effort to get the development resources.

When Eurex rolled out all the different changes to the infrastructure that was a huge effort to keep up, to get the resources put on, keeping up with those changes.

From the prop provider side as well that's going to be one of your major costs as well -- to keep up with those changes in the industry as well.

Jeffs: Let's just talk a bit about competition and how you see that playing out over time.

Heath: I guess competition is always good, as Mark mentioned, it keeps everyone honest. We do monitor the potential competitive threats out there, both existing and in the pipeline.

We understand the potential issues within the market. We see concentration risk, we see concentration in the number of FCMs able to provide that service and that's not good for us as a clearing house because there's concentrated risk.

It's the same all over the market, the costs are having such an impact you'll see firms just getting bigger to mitigate the cost. And that's everywhere, banks, FCMs, even on the buy side we've seen some mergers that are going on which again reduces the number of participants in the market.

> "We see concentration risk, we see concentration in the number of FCMs able to provide that service and that's not good for us as a clearing house because there's concentrated risk"
>
> **Stuart Heath, Eurex**

I think there's a lot of short-sightedness from other exchanges in jacking up fees all the time. What we need to do is look to how we develop the markets going forward and bringing on new traders to our products and bringing on new products for traders to trade.

Our biggest challenge at the moment is getting those new products to the level

> We've come up with the term "velocity" as a concept to describe the effects of fragmentation. Recognising changes in velocity and managing the different factors in your own way is the key to growth and innovation
>
> **Steve Woodyatt, Object Trading**

where the clearers will offer them to clients, where the ISVs will provide them and more importantly where the back office vendors make them clearable. It is a significant challenge, both in terms of efforts and in terms of the time to market.

I guess we're facing a challenge as well. We come from a position of strength. I don't think we underestimate how that could diminish quickly. We try and keep up with some of our programmes, such as our trader development programme, to help proprietary trading groups and at the same time data remains free to users of our exchange.

Kerr: How do you view the differences between different types of memberships at exchanges? I think Eurex is a reasonably level playing field, compared with some other exchanges where membership costs vary and improved latency access can be purchased.

Heath: One thing that we always try to provide, and it comes from the top, is a level playing field so everyone is treated the same. We won't put out any incentive scheme that's not available to everyone. I think our fee structure is fairly straightforward. We charge based on whether it's proprietary or client account business. Those fees can differ. The only other real change is whether you access the market through the order book or if you are block trading. But those are really the matrix of prices we have.

We still are wary of competition out there. We concentrate on making sure we provide the best service because we know that if we don't provide the best service people will club together and find a new exchange.

We are very aware of the regulatory issues out there and how they are impacting our trading groups and how they decrease revenue for us so we are going to do as much as we can to mitigate any negative impact.

Slade: The exchanges talk about liquidity provision being key but why would the market want to make an investment in a new trader today? We're all saying it's getting harder and harder, and if I have no incentive to do that, the return on my capital is much riskier and less attractive and I might as well go and put in a different business completely.

Exchanges have to incentivise us to bring on new people.

The entry fee to get into this market now is so much higher than it used to be. If you quote the CME now, you can pay for membership you'll get a far better return on your capital than if you're a non-member, which is not a level playing field at all.

Frewer: We're seeing more consolidation within the trading community even amongst the bigger proprietary trading firms, because of increased technology, operational and administrative costs.

There is still room for everybody in the present market. Tick day traders, those that trade using algorithms, to those with delta neutral models accessing them in conventional means, all add liquidity and competitive pricing to the wholesale and capital markets to offset risk.

Steve Woodyatt, CEO, Object Trading: Mark made an interesting point about the return on investment and capital. In fact it is getting to the point where you look at the opportunity cost and where you could deploy capital more effectively elsewhere.

Costs have gone down in some areas, but overall the total cost of ownership has gone up significantly, partly due to increased costs of back office compliance.

Mark was talking about investment in talent and really that's becoming a capital investment rather than an operating expense. You're going to have to carry people longer to get a return on that investment, so that's also going to increase your costs.

We look at the drivers behind return on capital and analyse the effects of fragmentation, be that fragmentation of products, exchanges or cross-border regulations and compliance.

We've come up with the term "velocity" as a concept to describe the effects of fragmentation. Recognising changes in velocity and managing the different factors in your own way is the key to growth and innovation.

There's been a massive increase in trading R&D portability. So now people can access more regional or developing exchanges, they will be porting systems at a faster pace.

So far we've concentrated on only one part of the velocity concept - trade latency. But it's all these things put together that make up the cost equation; and the technology response these days really has to be to address the complete package of costs for prop trading.

We see decreasing velocities in many areas such as the lifetime of a trading system. The lifetime of a system used to be maybe 12 months. These days it might be a matter of weeks or months, and you've got to tweak it and move on.

Collateral velocity is an interesting one for me, because it's decreasing rather than increasing. So the increase in regulation means that you can't move your collateral and your capital around as easily.

Because all of these velocity variables inside our marketplace are changing, firms need to have a tight control over costs as well as a platform that covers the majority of those factors, and gives the ability to respond effectively and efficiently. That is the key to remaining profitable and being able to grow in what is increasingly an aggregated market.

Jeffs: Mark, coming back to the point you made earlier on about exchange fees or the stealth taxes that you referred to. If you're so annoyed about the fact that the exchanges are jacking up these fees, why are firms like yours not doing more to support new ventures?

Slade: We are. We were founder members of NLX, but it takes all different people to make a market. You have to have the right blend of paper, natural flow, props and HFT to get extra quotes and actual activity.

Otherwise you end up with the props who generally are passive traders trying to trade with each other, which doesn't give you any natural business. I think seven or eight European props signed up to NLX and ICE had just bought Liffe so it made perfect sense at the time.

The horizontal clearing module as well made sense. But these new markets need more support than just the props. We can't do it alone.

Smith: NLX was were working very closely with the banks as well because everyone understands that you need the whole community to come together for it to be successful. It's just that different firms work at different speeds.

Heath: A big part of this is in timing. There are times when concentration is actually the best way to reduce costs. It is not just good for liquidity but also capital usage.

Put all of your trading and open interest into the one clearing house where you get the most margin offsets and you can reduce your capital charge significantly. That's the way the regulation has driven it.

Slade: And that filters down to us. It's better to have your collateral in one place, rather than fragmented across different clearers. But if your existing clearer doesn't sign up to a new venue, then you can't access it.

Smith: Or you have to find another.

Slade: And that means fragmented capital, no offsets etc.

Jeffs: Is now a bad time to be innovating and doing new things, launching new products or exchanges?

Frewer: We have to. A large proportion of cleared business is fixed income and the outlook for the yield curve looks relatively flat for at least a year. The fact is that we've all got to look at different markets to diversify.

Voinchet: And we need new products as well. Competition doesn't necessarily come from trying to release the same products as those traded on other exchanges. When Eurex launched Eurex US the investors stuck to what they know

> "Then there are costs associated with offering more opportunities to clients and we have to evaluate whether a new exchange is going to be a venue which will attract volumes"
>
> **Martin Frewer, ABN Amro**

and eventually it failed.

What we want is new products. For example I like the strategy of the Dubai Gold and Commodities Exchange - they aren't trying to do what the others are doing. Instead they are looking at things like plastics and the Indian rupee. That's what we need in Europe, new products and more innovation.

Slade: The big guys are in a real position of strength here. Eurex's approach with Gmex is interesting. It might work, it might not but it's a relatively small investment to back a new venture.

Woodyatt: ICE and Eris cutting that licensing agreement is another example.

Slade: I can foresee in the future though that the big guys will always pick up these smaller initiatives, and if they work they are going to take them over. And then the competition has disappeared again.

Woodyatt: So maybe that's the new business model. The large exchanges offer the product distribution strategy. We've seen two cases now where there's been a licensing of product and technology to bigger exchanges who have the distribution capability. Again, it's a form of aggregation.

Slade: It makes sense for us because we can access it much quicker than we would have been able to had they gone on their own. But on the flip side, we've got a situation where the larger incumbents are in control of the fee structures.

Heath: When we announced the listing of the Gmex product, we had a lot of phone calls saying thank goodness, it makes it a lot easier to access, but again it brings us back to the concentration point.

You mentioned two products - there are a number of other ones out there. But I don't think we've lost innovation with these deals, we're also pushing our own products out there. We are trying not to copycat other people's products.

Probably listed repo and swap derivatives are going to be the next thing in Europe, but this strongly depends on the future regulatory agenda and timetable. So there is innovation out there but it is the larger firms who lead that as they can mitigate the costs front to back.

Woodyatt: So there is innovation from the exchanges in the form of clearing house initiatives and the migration of over-the-counter to exchange-traded derivatives. From a prop perspective, there has also got to be innovation in the business model and the way you run your business. Eldon's referred to it, Mark's referred to it and Rob and Didier are right in the thick of it at the moment.

Innovation and growth are enhanced by technology but it's getting the business model that fits the time that is really important. It's the same for us as a technology vendor. We're got to transform ourselves to meet the demands of the current market.

Frewer: We're all being a bit negative going on about costs, because if you think about what's actually going on, there's an awful lot of opportunities out there. You've got falling oil prices and all sorts of different macro-economic factors that will impact volatility.

Volumes recently have been relatively good. In the last quarter we've had two or three days of record volumes and there's also been a steady flow of volume coming out of equities into the derivatives markets.

Kerr: 2015 has a lot of headline items that should cause volatility, I hope that it's going to be good volatility. The Grexit, the euro instability, low oil prices and higher interest rates will provide trading opportunities.

Frewer: On the clearing side over the last 18 months there have been new entrants coming into the GCM space and it feels that consolidation is slowing. There are three or four new firms in London who have got meaningful intentions that aren't the traditional clearing organisations of the past.

Woodyatt: So rather than the 'woe is me' attitude - it's not about the regulations, it's not about the costs, it's about your business and how you operate.

In the prop area what I'm seeing is a number of very smart operators, some are here today around this table, which are concentrating much more on the alpha generating strategies, and investing a lot of their cost into a USP.

It's no longer a volume business where scalping is a profitable strategy. Rather than worrying about the bottom line on the cost, successful firms today are focusing on where they're investing. In the prop arena, that means investing in people, the trading system, market system combinations and asset allocation of capital.

To be competitive, you've got to have a cap on your costs, and able to access all the various different technologies required to execute those strategies in a cost efficient manner.

For a long time prop groups assumed that the complete stack, including technology development, was part of their value proposition, and I would argue that's no longer the case.

Firms today should focus on what truly generates value. And that is the trading strategies and the people.

Jeffs: Looking ahead, what are the attributes that will define the next generation of prop traders?

Slade: Flexibility. I don't think it's any different to the floor days. The strategy that you used on the floor in 1996 might not have worked in 1997. You've got to be flexible enough to change to market conditions, and the way the market moves.

Voinchet: I would say almost the same: adaptability. Darwin said that it's not strongest or the cleverest that survives, it's the one who is most adaptable.

We need to adapt, and we need the support of the clearers, we need the support of the exchanges, to launch new products and to be incentivised to trade them.

We need to be competitive, and we need to be successful as well. We need to dare and to innovate all the time. We have the opportunity, we have the people who are audacious enough to succeed.

> "Asking ourselves if we are better off bringing in an ISV or hiring a bunch of guys to rewrite the same thing that everyone else has written. Frankly I don't think that's the answer, but I think people still get caught in that trap of thinking they can do it better themselves"
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> **Robert Smith, Applied Financial Technology**

Smith: I think Steve put it very well: it's about focusing on the trading strategy itself, and from that point figuring out what your competitive advantage is. Asking ourselves if we are better off bringing in an ISV or hiring a bunch of guys to rewrite the same thing that everyone else has written. Frankly I don't think that's the answer, but I think people still get caught in that trap of thinking they can do it better themselves.

In the early days, no one else was doing it, so we did it better than anyone, because there was a very small set. But that's not the case anymore. There are a lot of solid products on the market that are going to get you 99.9% of the way to where you want to get to. So instead of devoting your resources reinventing the wheel and writing exchange tags, or even writing risk systems, think about what your trading strategy is.

The globalisation of the markets and levels of access to exchanges today opens up a lot of doors that did not used to exist. And so just taking a fresh look at the opportunities in the marketplace is really where firms of the future need to go, and understanding competitive advantages.

Kerr: The mentality of the next generation of prop trader is going to be the same as it always has been, the trading approach will change and adapt. I think that when the high frequency game plays out, it's going to be increasingly difficult to write an algo that can find little blips, and make money, so you're going to need those kind of systematic trading abilities, but with a discretionary overlay that can provide more variability, and make the strategy more profitable.