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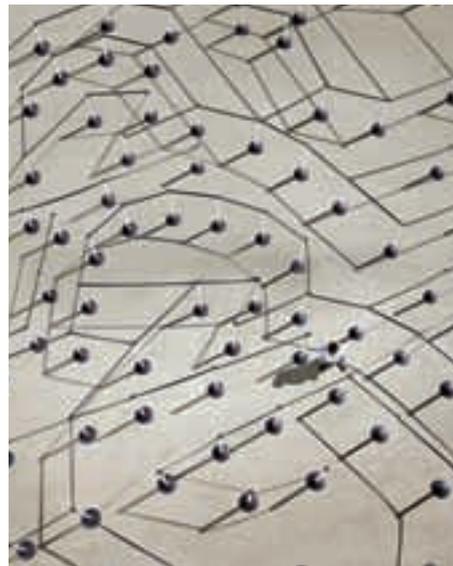
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2011

Volume 7 Issue 4

“Once you have this gap period between when the U.S. goes live and the rest of the world goes live, it creates a period in which business will flow someplace else.”

THOMAS RIGGS
MANAGING DIRECTOR
GOLDMAN SACHS



ON THE COVER

Financial regulatory reform has been slower to take shape than anticipated. How will staggered financial regulations on different continents affect the trading environment?

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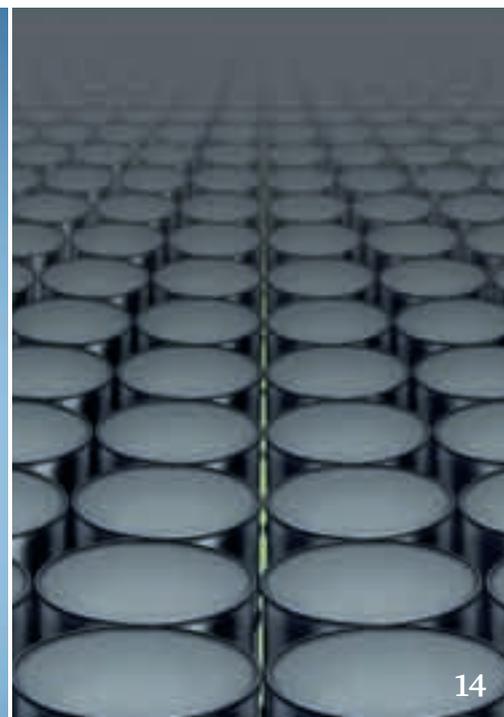
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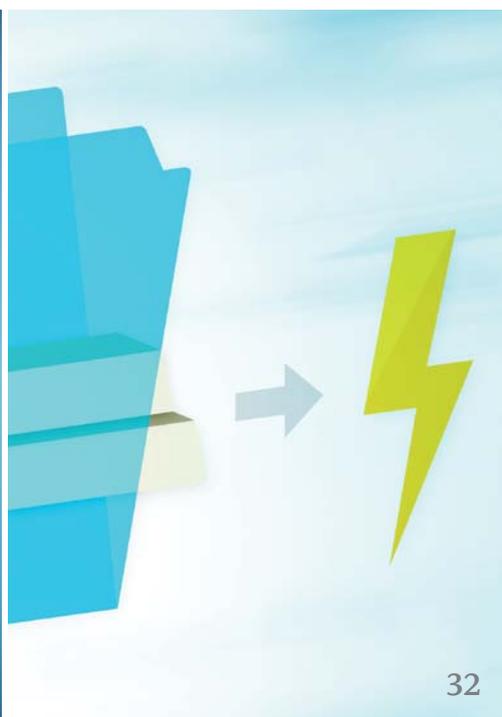
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Craig Donohue (left) and Terry Duffy (right)

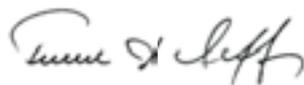
FROM THE TOP

The year 2011 has been one of anxious anticipation by market participants as they analyze and await proposed reforms from government agencies. In Europe, the legislative process is still largely underway, with detailed rules for financial services trailing behind the timeline in America. But, the question that the world still faces is, "How do we navigate this unpredictable path?"

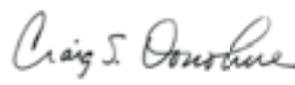
In our cover story, we explore the rules, regulations and timelines that are being prepared and will ultimately determine what the final picture will look like. We also examine how investors and institutions in an increasingly globalized financial services marketplace will respond to the shifting rules and staggered deadlines. This issue of *CME Group Magazine* features several trends borne out of post-financial crisis corrections, including:

- The private-to-public debt shift taking place in the United States and Europe,
- The embrace of new interest rate products by market participants hoping to weather economic conditions,
- The globalization of centralized clearing for over-the-counter derivatives,
- And the post QE2 environment in the wake of poor economic data and the downgrade of U.S. debt.

We are also pleased to announce an exciting change for *CME Group Magazine*. Beginning in 2012, the magazine will move to a digital-only format available online. It will merge with our blog and be re-named *OpenMarkets*. The approach will enable us to provide more timely updates in an environmentally friendly way, while still delivering the in-depth content we always have. We thank you for your readership over the years, and hope that you will continue to engage with us through our new electronic publication. The *OpenMarkets* site will be live next year, but until then, you can still find us online at www.cmegroup.com/magazine.



TERRENCE A. DUFFY
Executive Chairman



CRAIG S. DONOHUE
Chief Executive Officer

THE GREAT DEBT SHIFT

*The Risky World
of Private-to-Public
Debt Shifting*





The United States and the European Union have each absorbed massive amounts of private-sector debt in attempts to contain their financial crises. The success of the U.S. effort, despite the debt ceiling wrangle and the sovereign downgrade it precipitated, contrasts sharply with Europe's experience and provides important insights for fixed income and currency market participants.

This summer, the bruising political battle over the debt ceiling, and Standard & Poor's subsequent decision to lower the United States' sovereign rating, displayed some of the unanticipated consequences of the government's policy responses to the Great Recession. But its assumption and/or guarantee of hundreds of billions of dollars worth of financial-sector obligations did allow most U.S. banks to offload troubled assets, secure liquidity, recapitalize balance sheets and return to profitability.

This contrasts sharply with the scenario playing out in the European Union (EU), particularly in its southern periphery. Three years after the U.S. financial nadir, the EU is still struggling to engineer a credible package of private-to-public debt shifts and backstops, in its attempt to avoid the uncontrolled default of some of its weakest and most indebted members, notably Greece, Italy and Spain.

In the United States, the private-to-public shift occurred relatively decisively, despite political grumblings. The Federal Reserve's various emergency lending facilities, the government-backed shotgun marriages of Bear Stearns, Wachovia, Merrill Lynch and Washington Mutual, and the \$700 billion Troubled Asset Relief Program (TARP) avoided more Lehman-like catastrophes and inflated asset prices enough to allow U.S. banks to recapitalize, while government support of the money fund and commercial paper markets kept them from collapsing.

The U.S. interbank and wholesale borrowing markets are now back in business. And, despite some market trepidation regarding the potential effects on bank earnings and stock multiples from the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Basel III capital accord, most U.S. financial institutions have been able to boost their equity and repair their balance sheets.

This type of private-to-public debt shift has yet to happen at the scale necessary in Europe for the region's troubled banks to regain their footing. Since most of the banks are guaranteed, tacitly or not, by their governments, and peripheral countries such as Ireland, Portugal, Greece and Spain are suffering from massive debts and deteriorating economies, the only public entity capable of assuming the debt is the EU itself.

But the temporary €750 billion European Financial Stability Facility (EFSF) established in May 2010 to provide emergency backstops for sovereign issues has not proven large enough to deal with all the troubled countries that need it. "The EFSF was meant to scare speculators off; the EU hoped never to use it," says Steven Major, global head of fixed income research at HSBC Bank plc. "But the market saw it as a red flag."

SOVEREIGN APPEAL

"In Europe, most of the strains are due to the market testing the willingness of politicians to accept that debt shift," says Michael Story, London-based economist and product specialist at Western Asset Management Company (WAMCO). "If the EFSF had been expanded to €2 trillion, or there was a full fiscal union, there wouldn't be these strains in the periphery now."

The EFSF will be replaced by a permanent facility, the European Stabilization Mechanism (ESM) in mid-2013. Early work on the EFSF suggested it needed to be €1.5 to 2 trillion to appear credible to the market, Story says, but the political will for such a fund was lacking. Backstopping Ireland, Portugal and Greece has already used more than half the fund's capacity, and problems in Spain and Italy would require more than the roughly €300 billion left.

Ad-hoc measures are filling the gap, for the time being. These include large European Central Bank purchases of Italian and Spanish debt on August 8, 2011, which, in conjunction with ongoing interventions by the Spanish and Italian central banks, managed to drag their 10-year yields under the six percent level, above which they had been trading. Analysts believe a seven percent yield would be unsustainable.

Despite this, the EU's lack of fiscal union, worries about core countries' willingness to support the periphery, and the fact that those peripheral countries do not control their own currencies and are therefore subject to credit risk remain substantial worries for lenders. They also highlight the reasons the U.S. private-to-public shift has been a qualified success, while European efforts have not yet borne fruit.

"Truly sovereign countries like the U.S., the U.K. and Japan have their own currencies. There is no measurable credit risk," says HSBC's Major. "But where you don't have control over your currency, it's a different matter."

This is the problem in the EU. Without control over their currencies, individual countries could, indeed, default. That is why the peripheral EU countries have seen their costs of funds rise sharply, while the 10-year U.S. Treasury Note was largely unfazed, even during possible talk of default during the debt ceiling brinkmanship. Nonetheless, few market participants remain willing to consider U.S. debt truly "risk-free."

In the United States, the private-to-public shift occurred relatively decisively, despite political grumblings.

The situation is analogous to a bank run. In the United States, the market has confidence in the "deposit insurance," meaning the credibility of the government's backstop, and therefore doesn't feel the need to demand more return to compensate for default risk. In Europe, the deposit insurance – in this scenario, the bailout funds – are not seen as large enough to be credible, so lenders demand to be paid for credit risk.

This led to a self-fulfilling dynamic in July 2011. "Higher yields hurt the peripheral economies, which in turn justified the higher yields," WAMCO's Story says. This puts policymakers in a bind. Wanting to regain the market's confidence, the EU issued a statement on July 21, 2011, reiterating its member countries' commitment to three percent deficit ceilings by 2013. But the government cutbacks and austerity programs necessary to achieve that goal could hurt their economies, lowering growth rates and, in turn, making debt servicing more burdensome.

When deciding just how burdensome, some analysts use the heuristic ratio of public debt to gross domestic product (GDP). This can be misleading. What HSBC's Major calls "true sovereigns" can support much higher debt-to-GDP than other countries. Japan's public debt in 2010 was more than 150 percent of its GDP – the world's highest – yet few worried about its solvency. Greece and Italy, on the other hand, rank fifth and eighth, with 144 and 188 percent, respectively.

FLIGHT TO QUALITY

All this has been a boon for the U.S. dollar, despite ultra-low interest rates. Indeed, despite the uncertainty caused by the U.S. downgrade, the debt ceiling battle and the poor economic indicators released in late July, the dollar has held its own. "At the height of the crisis, there was a flight into Treasuries," says Derek Sammann, managing director, FX and interest rate products at CME Group. "People were buying dollar-based assets, so they needed dollars."

The dollar and U.S. interest rates are benefitting from the government's decisive moves to recapitalize its financial sector in 2008 and 2009, and from its safe-haven status, just as Europe's lack of market credibility and cumbersome decision-making process have hurt the euro. Nonetheless, the uncertainty introduced by weak economic indicators in the United States and the unknown fate of Europe's emergency measures, combined with the growth of public debt globally to around \$50 trillion, has made careful hedging a top priority.



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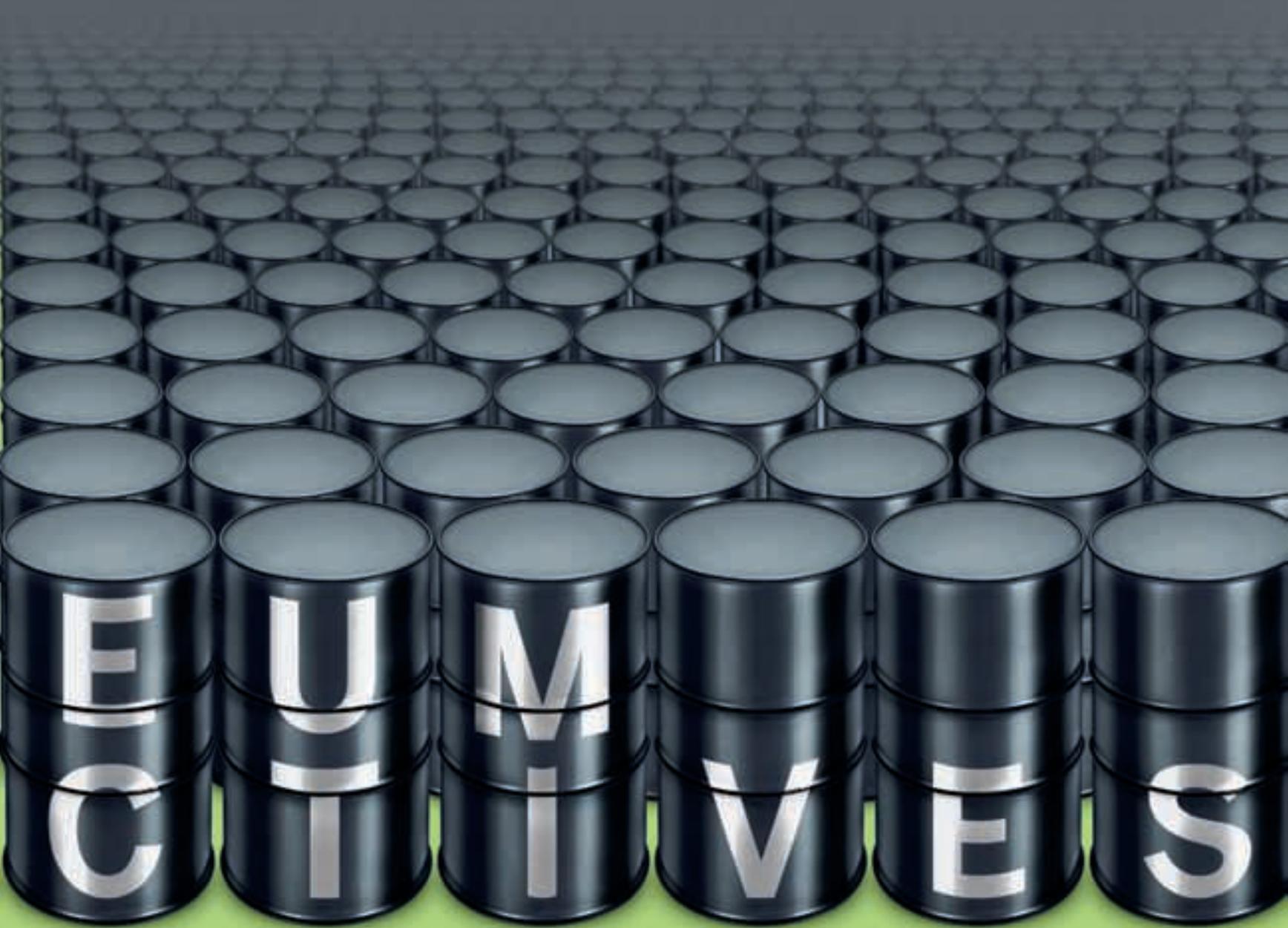
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Amid Libyan sanctions, the International Energy Agency took action in June to keep the world's oil spigot at full flow. Price swings followed this new wrinkle in supply uncertainty. But the move to open reserves was only a taste of the volatility to come.



When the International Energy Agency (IEA) tapped the strategic petroleum reserve in late June 2011, pouring some 60 million barrels of oil onto global markets to help make up for supplies lost to Libya's civil unrest, investors and hedgers spent the subsequent weeks in a defiant drive that took West Texas Intermediate (WTI) crude futures back to \$100 a barrel. It was a sign of what was to come—weeks of a volatile supply and demand push-and-pull that culminated in a price drop to 11-month lows below \$80 by early August.

Price predictions now hinge on whether the globe will tip back into recession. Some analysts see WTI near current levels through year-end—a range of \$75 to \$102.

In addition, unusual market behavior is reflected in the ongoing futures price inversion that has WTI uncommonly trading at a record discount to European Brent crude (see, “A Complicated Relationship” on page 16.)

That wedge held as weak consumer spending and manufacturing data compounded the jitters brought on by the 11th-hour passage of

the U.S. debt-ceiling extension. Surging borrowing costs for new European bond issues had a similar effect, although a European Central Bank pledge to buy bonds did help. Now, the United States faces its own jump in borrowing costs after Standard & Poor's downgraded its sterling AAA credit rating one notch to AA-plus.

“With the IEA move and because the Libyan production issues, while important, didn't spill over to its neighboring producers, I think the market, at least since May, has shifted focus toward the demand side—the debt cri-

sis in the euro-zone and the U.S.," says Robert Johnston, head of global energy and natural resources at political risk consultancy Eurasia Group. "This, of course, impacts currency markets and as a result, impacts oil markets." Unrest continues in Syria, Yemen and elsewhere, but the production disruption did not spread as first feared.

The \$100-plus territory that WTI hit after the IEA move was below the \$115 of earlier in the year and the all-time record near \$147, but notably was some \$10 higher than where front-month futures traded as the Paris-based group approved its rarely used 30-day release. Brent futures revisited the 2011 highs near \$126 a barrel as mid-summer approached but dropped below \$107 in the wake of the U.S. downgrade.

Unrest continues in Syria, Yemen and elsewhere, but the production disruption did not spread as first feared.

CREDIBILITY COMPROMISED

Clearly, pricing volatility fueled the criticism that some market participants leveled at the IEA. Their move followed an acrimonious meeting by the Organization for Petroleum Exporting Countries (OPEC) in June, in which all of OPEC but Saudi Arabia decided against an increase in output.

"If OPEC bruised its reputation by its collective failure to find consensus on production policy at a June meeting, consumer countries acting through the IEA have gone a good step further, raising reasonable questions about the agency's long-term market credibility," says Bill Farren-Price, chief executive officer at U.K. consultancy Petroleum Policy Intelligence.

The United States opened up its own reserves in a coordinated effort with the IEA. The release's short-term impact, according to the agency, was effective in bridging the gap until OPEC and an independent move by Saudi Arabia could make up the production difference. Libya is the world's 12th largest exporter, pumping a pre-conflict 1.58 million barrels a day.

If anything, the IEA's move was more an action of supply shift. Most of the crude in the release was sold in the United States, displacing its more usual imports and prompting a major rerouting of product flow, including bringing more West African crude into the global mix. Meanwhile, Saudi Arabia has increased production of lower quality crude, partly compensating for the higher quality oil that Libya had sent to European refiners.

Olivier Jakob, managing director at Zug, Switzerland-based consultancy PetroMatrix, anticipates balanced net global supplies into year-end.

"Given that the strategic petroleum reserve (SPR) release is occurring now and that, as of September, the U.S. refinery crude oil demand starts to ease for seasonal reasons, we think that the SPR release will guarantee that the U.S. stays very well supplied until the end of the year," Jakob says. He adds that he does not expect any change to OPEC output this year, but that Saudi Arabia will act on its own.

SHORT-TERM DEMAND IN DOUBT

Consumer and business sentiment data from North America, Europe and China hit within a few days of each other. All missed the mark. With U.S. debt management in question, the dollar fell to an all-time low against the Swiss franc and slid against the yen, prompting Japanese currency intervention. A weaker dollar is oil-supportive because it makes crude priced more attractively on global markets. But because the decline was symptomatic of a weakening global economy, crude futures got little traction from a softer greenback.

In fact, the U.S. Department of Energy in May lowered its estimate for the country's oil consumption to 18.36 million barrels a day, down 2.5 percent from the same month last year. Demand fell in April as well. The U.S. had not endured two consecutive months of year-on-year crude oil demand decline since October-November 2009.

China's contribution to demand, some 11 percent of the globe's total consumption, looks to moderate, explains Eurasia's Johnston.

"China will still have a very stable crude and GDP outlook, but we don't expect to have the big move of 2009 or the big up-years like in 2006 or 2004 with the power crisis there," he says. "You're

A COMPLICATED RELATIONSHIP

Brent crude is trading above global benchmark West Texas Intermediate (WTI) crude by as much as a record \$23 compared to near parity at this time in 2010. For the past few years, falling U.S. Midwest inventories have usually resulted in a narrowing of the Brent-WTI spread, which typically stands at an average \$5 in favor of WTI.

"It is a pricing relationship that the market has been able to sustain," explains Robert Levin, managing director, energy research and product development, at CME Group.

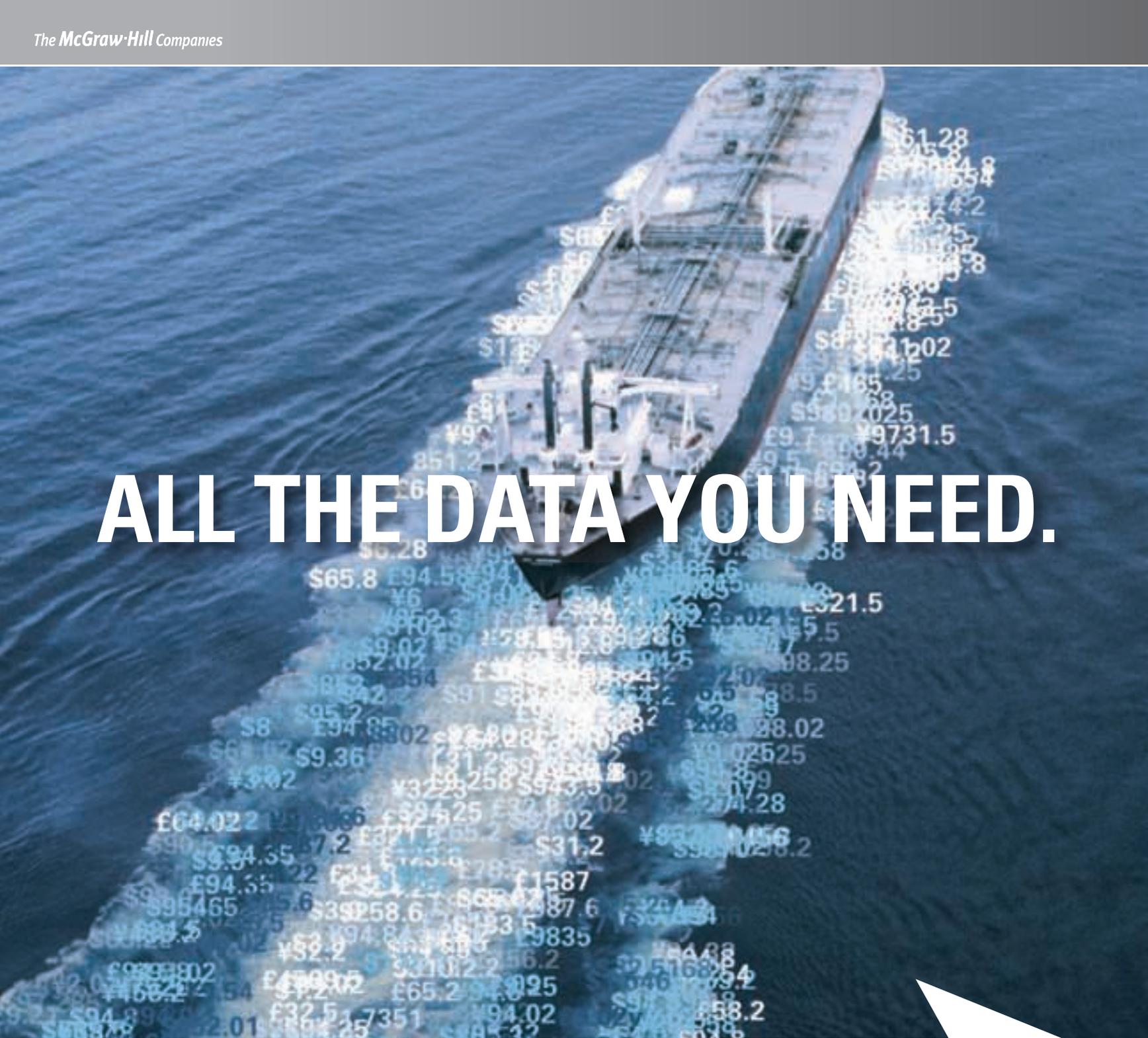
Brent's gap has been growing since January 2011, in part because Midwest hubs in Cushing, Okla. are receiving more supply from oil fields in North Dakota and Canada, but have not yet built enough pipeline to pump the incoming crude further south, though plans are underway to address this issue. Other analysts note tighter supplies in Europe's North Sea, which is problematic for Brent.

Cushing, Oklahoma, has expanded its massive tank farm to help accommodate an expected onslaught of crude from further north. But production in the Bakken Shale of North Dakota has gone from virtually zero to around 400,000 barrels a day in the space of a few years, and U.S.-bound shipments from Canada have surged. Yet, observers believe greater upgrades to pipeline and storage capabilities will be necessary to ultimately provide a solution. Indeed, a massive Canada-to-Gulf Coast pipeline project known as Keystone XL will soon be voted on by the U.S. government.

seeing expectations for strong, steady demand growth but not the swings we had seen."

Peter Beutel, founder of U.S. energy risk management consultancy Cameron Hanover, says that while a double-dip recession may not come to realization, a slow-growth picture could continue. Even with the latest pullback, oil prices may prove too steep to allow an economic recovery from such a deep recession.

The Federal Reserve will be the key driver of oil prices, Beutel says. Should the Fed push through another round of its quantitative easing program, Beutel would add another \$25 to his current \$75 to \$85 year-end WTI projection.



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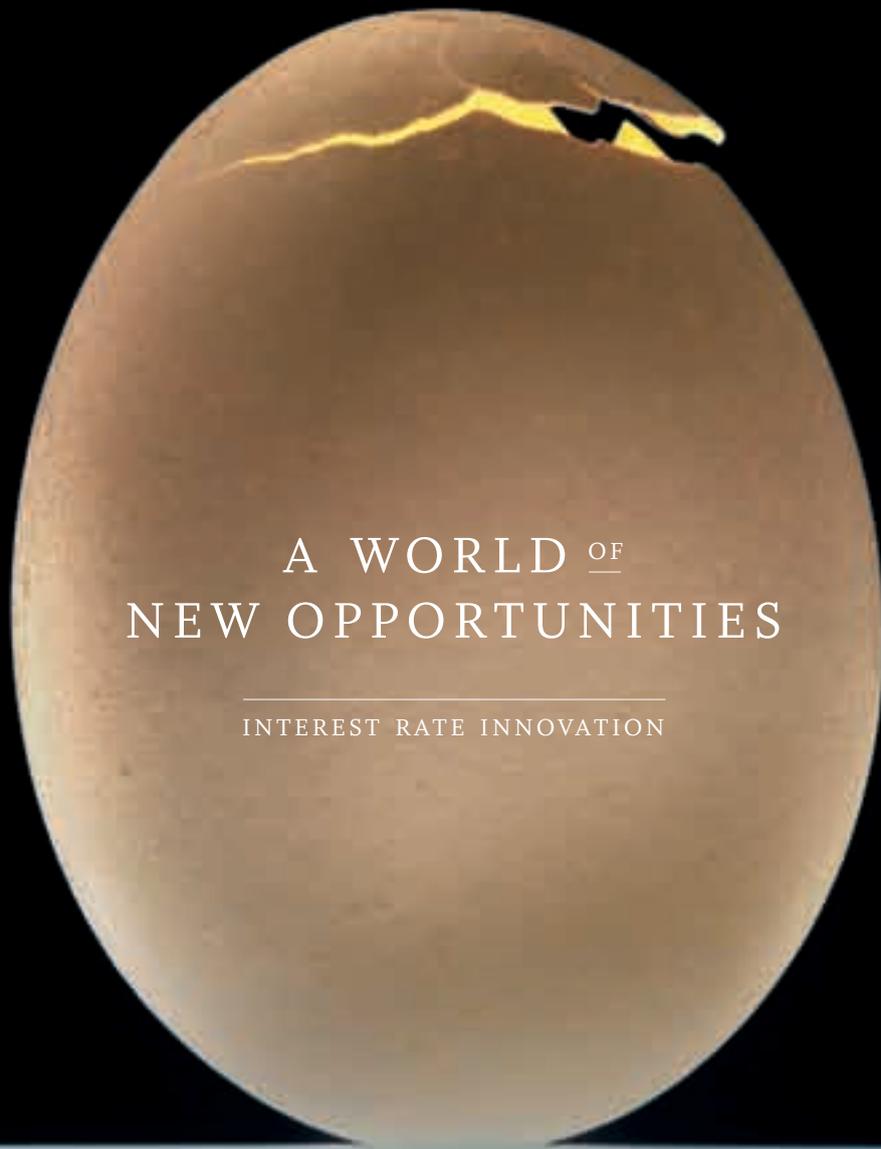
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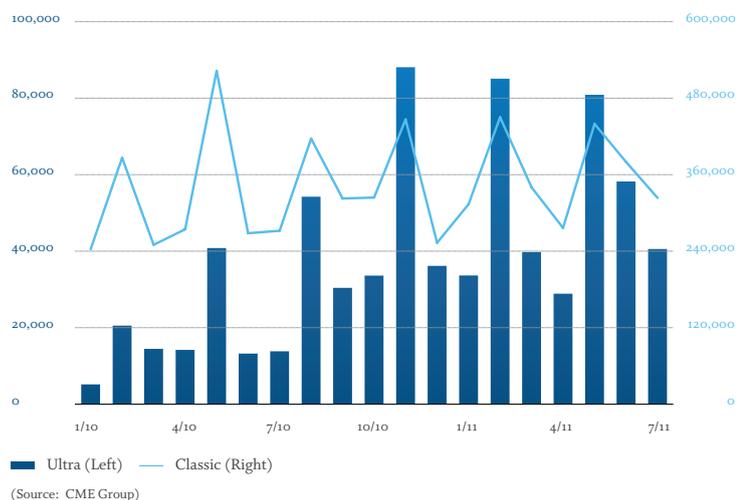
In times of economic and financial market turmoil, market participants tend to retreat to using the standby products they know. However, if turmoil causes change in the market structures and costs of capital go up, hedging needs can change, and that is where innovation finds its opening.

OVER THE PAST FEW YEARS, several new interest rate products have been introduced, a number of which have been wholeheartedly embraced by the trading community, and others that are largely still waiting to be discovered. The products range from contracts that focus on the near-term, such as weekly Treasury options, which are driven by events or headlines, to those that target the longer term, such as the U.S. Ultra Treasury bond futures (Ultra T-Bonds).

Now with Standard and Poor's U.S. credit rating downgraded to AA+, market participants will "look for new ways to skin the cat," says Mike Donohue, an independent trader and industry veteran. "Anything based in the U.S. will now move."

ULTRA AND CLASSIC U.S. TREASURY BOND FUTURES

Average Daily Volume, January 2010 - July 2011



Donohue, who managed proprietary trading firms in Singapore and Australia before recently returning to Chicago, has been trading sovereign debt for more than 15 years. He was a staunch proponent of CME Group introducing a Sovereign Yield Spread futures (Sovys) contract, anticipating that there was a potential for things to unwind in the sovereign debt space. He wanted a product that could take advantage of the interest rate differential and would allow for simpler, more cost-effective and more efficient trading and monitoring of sovereign bond spread positions.

Indeed, Derek Sammann, CME Group managing director, FX and interest rate products, calls the exchange's Sovys contract, introduced in May 2011, a "true game changer." The contract wraps a sovereign bond yield spread into a single futures contract, eliminating the need for market participants to execute and

manage individual legs in the cash bond markets or across multiple exchanges. It incorporates bonds from the most liquid sovereign debt markets, including the United States, Germany, France, Italy, the Netherlands and the United Kingdom.

Sammann says that when volatility surfaced a year ago with uncertainty in Europe, it became clear that clients wanted to trade sovereign debt.

Adding to the interest in new contract offerings is the Dodd-Frank Wall Street Reform and Consumer Protection Act. Market watchers anticipate that under the act, the costs of trading over-the-counter (OTC) market products will go up, leaving market participants looking for products that are more transparent and capital efficient.

Ultra T-Bond futures, which launched in 2010, provide market participants with a direct way to manage long-term interest rate risk and add duration to their portfolio. The key feature distinguishing the Ultra T-Bond from the existing 30-year U.S. Treasury bond futures is the relatively narrow range of deliverable securities.

"The Ultra will be a useful substitute for anyone who has that kind of a need," says Amrut Nashikkar, U.S. fixed income strategist at Barclays Capital.

According to John Brosnan, head of fixed income trading at XR Trading, the Ultra bond has brought tremendous value to a relatively under-served duration point on the yield curve. Prior to its creation, most long-dated risk was mitigated using swap, cash Treasuries and other OTC products.

"The Ultra bond is truly unique in the sense that it gained immediate market acceptance and it continues to grow in popularity and utilization," he says. "I firmly believe that it will serve as the litmus test for successful product launches in the futures industry."

Brosnan adds that as yields accelerate toward unprecedented lows, opportunities to mitigate risk at the front end of the yield curve appear to be diminishing. The long end, as of late, has served as a better "risk-off" proxy for safe-haven investors. "This is atypical behavior, but probably something that will increase participation in the Ultra bond for months, if not years, to come," he says.

Other new interest rate products are slowly gathering open interest at the exchange. On-The-Run (OTR) Treasury futures are a cash-settled contract that settles to the yield of the on-the-run-Treasury. Because it is a physically delivered contract, the contract tends to track the cheapest-to-deliver. The OTR futures are used to create basis spreads with minimal margin requirements.

Weekly Treasury options complement the standard options and the flexible options on U.S. Treasury futures and give market participants the opportunity to trade specific news events – such as the nonfarm payrolls report.

But Sammann notes that technology also can be innovative. In August 2011, CME Group started the ball rolling on a number of enhancements to its interest rate futures on CME Globex, its electronic trading platform. The migration to a new matching engine increased the speed and efficiency of trading. Enhancements included faster round-trip turn times, along with the ability to modify orders multiple times without waiting for an acknowledgment from CME Globex on enhancements to the existing order modification process.





The

UNPREDICTABLE PATH

The Global Regulatory Puzzle

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Financial regulatory reform has been slower to take shape than anticipated. Regulators continue to mull over key provisions ranging from what defines a systemically important financial institution to the clearing of over-the-counter derivatives. Of equal concern, misaligned financial regulations in the United States, Europe and Asia could result in a less-attractive U.S. trading environment.

In an ideal world, global financial regulators would function something like a team of horses, with policymakers in the United States, Europe, Asia and elsewhere all pulling at once in the same direction, and moving toward a common goal.

Reality is turning out to be far more chaotic. Regulators and lawmakers are having a tough time forming a consensus even within their own national borders, let alone across international boundaries. The result is turning out to be a patchwork of overlapping and often inconsistent approaches to regulation in the aftermath of the financial crisis that gripped global markets in 2008 and 2009. Many financial experts fear that the inconsistent global regulatory framework will alter the flow of capital around the world, as trades are directed to the cheapest jurisdiction, a process known as regulatory arbitrage.

ONE STEP AHEAD

U.S. regulators are moving faster than their counterparts in Europe to develop and implement new financial regulation, and appear likely to take a stricter view when it comes to granting exemptions to the new rules. The United States has passed the legislative phase and is now implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, albeit a bit more slowly than Congress intended. In Europe, the legislative process is still under way.

Tom Riggs, a managing director at Goldman Sachs, sounded an alarm about that gap at an industry roundtable convened this past summer by U.S. regulators. "Once you have this gap period between when the U.S. goes live and the rest of the world goes live, it creates a period in which business will flow someplace else," Riggs said during that discussion. "When the rest of world harmonizes with the U.S. approach, the question is, can you get it back?"

U.S. regulators do not appear particularly susceptible to such pressure. "Why should we wait until other countries initiate it five years down the road? Then the momentum goes away," Ananda Radhakrishnan, the head of clearing and intermediary oversight at the U.S. Commodity Futures Trading Commission (CFTC), asked Riggs. "I realize some of you want that momentum to go away, but from our perspective, we can't let it go away."

Industry concerns are nowhere more pronounced than in the \$600 trillion market for over-the-counter (OTC) derivatives, where U.S. and European regulators are headed down separate paths. "The difference will be capital," says Simon Gleeson, a partner with the law firm Clifford Chance, in London.

Regulators in the United States want to see as many derivatives transactions as possible go through a clearinghouse, in which performance bond—deposits required to ensure that a counterparty can cover the trading position's potential losses—is a requirement, prices are transpar-

ent and losses are absorbed by member institutions, not the taxpaying public. "The U.S. takes the view that clearing is a positive good and should be required as widely as possible," says Gleeson, who specializes in financial markets law and regulation.

The result will create a cost disparity between OTC transactions in the United States and Europe because submitting a trade to a clearinghouse, for clearing and settlement, could be more expensive than conducting an OTC trade for certain market participants. Clearinghouses apply the same performance bond requirements to all members, across the board. Positions are mark-to-market twice a day, with performance bond requirements adjusted to reflect current market conditions. In contrast, OTC trades rely on the individual counterparty's creditworthiness, rather than market conditions, to determine margin requirements. The result is that many institutional traders, such as pension funds and sovereign wealth funds, simply do not post collateral.

The prospect of higher costs compounded by confusion and uncertainty over the yet-to-be-completed regulatory overhaul is a source of anxiety and frustration for derivatives users, according to Andrea Kramer, a partner with law firm McDermott Will & Emery in Chicago. "I have clients who are about to throw up their hands," says Kramer, head of the financial products, trading and derivatives group.

So far, Europe appears to be taking a more fluid approach to OTC margin and capital than the United States. In the U.S., for example, derivatives users will face clearing requirements if they have more than \$50 billion in assets. In Europe, clearing requirements for corporate users will be based on a less cut-and-dried "business assessment test," according to Anthony Belchambers, chief executive officer of the London-based Futures and Options Association. "The European approach has been a bit more pragmatic and consultative. I think that is the main difference," he says.

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It is not clear that all the advantage will flow to one jurisdiction or another. There are instances in which U.S. markets may be at an advantage, according to Ruben Lee, founder and chief executive officer of Oxford Finance Group, a consulting firm in London. The European Parliament may extend the scope of derivatives clearing requirements in the European Market Infrastructure Regulation (EMIR), which would make them more consistent with Dodd-Frank rules in the United States. In a similar market, the United States may be viewed as relatively more efficient, according to Lee, a former fellow at Nuffield College at Oxford University, and author of *Running the World's Markets*. Part of the reason is market structure: the United States has essentially one major clearing-house while there are about 30 in Europe. A multitude of clearinghouses can lead to economic inefficiency and higher costs. "The clearing argument may yet play out in favor of America," he says.

After the European Parliament completes the EMIR legislation and the European Commission completes its Markets in Financial Instruments Directive, the U.S. and European markets could still end up looking more similar than dissimilar. In that case, the OTC derivatives market could shift to a market in Asia, such as Singapore, where margin and capital requirements are likely to remain relatively inviting.

But if there is an opportunity for regulatory arbitrage, traders will take it. "And there is very little that regulators can do about that," Gleeson says.

While regulators cannot do much to curtail corporations in their countries from shifting their business to other countries, they can crack down on cross-border business, according to Gleeson. "They can tell them that if you are going to conduct business outside of the U.S., you must conduct it entirely outside of the U.S.," requiring them to set up foreign subsidiaries for offshore booking. That might not be a problem for

It is not clear that all the advantage will flow to one jurisdiction or another. There are instances in which U.S. markets may be at an advantage.

large multinational corporations, but it could be a major hindrance and expense for the increasing number of small and mid-sized companies that do business abroad.

The extension of Dodd-Frank margin requirements to international businesses is also a source of concern for U.S. banks. The International Swaps and Derivatives Association sketched out the problem in Senate testimony. It posed a hypothetical situation in which an Italian bank does business with the U.K. subsidiary of a U.S.-owned bank, and is subject to Dodd-Frank margin and collateral requirements. An Italian bank doing business with a U.K. bank would likely be subject to less stringent margin requirements. That difference could create a competitive disadvantage for U.S. banks. And the global nature of the derivatives market could become more domestic.

"I think five years down the road, the markets may largely separate," Gleeson says. "You may have a U.S. market, for U.S. companies doing business domestically, and a non-U.S. market made up entirely of people that are not counterparties in the U.S. and not subject to its regulation."

ARE WE THERE YET?

Is the implementation of Dodd-Frank imperiled? As of summer 2011, regulators had completed only 33 of the 163 rules that were required by the 2010 legislation, written in response to the financial crisis, according to a report by law firm Davis Polk & Wardwell. That is a completion rate of just 20 percent. The July 15, 2011, deadline for rules required of the U.S. Securities and Exchange Commission (SEC), one of the key agencies responsible for Dodd-Frank implementation, was postponed until the end of the year.

While many of the law's provisions have sparked resistance among financial industry executives and some Republican lawmakers and regulators, the delay mostly reflects the enormity of the task at hand, says John Taft, chief executive officer of RBC U.S. Wealth Management, and chairman of the Securities Industry and Financial Markets Association, an industry trade group.

"We said from the beginning that the process of writing and implementing rules for Dodd-Frank would be a two-to five-year process, and that is still

likely to be the case. And we don't think that is a bad thing. It is better to take more time and get it right."

The third quarter of 2011 is supposed to be a critical time for rule making as the deadline for 122 of the 163 rules is supposed to pass during that period.

In truth, the securities regulators are even further behind than they might appear, because bank regulators have finished 37 percent of their rules. The SEC and the U.S. Commodity Futures Trading Commission (CFTC) have completed just 18 percent and 17 percent of their rules respectively, and other regulators are even further behind, according to the Davis Polk report.

One major area of confusion: the SEC and the CFTC don't agree on how many bids should be required to have in order to achieve best execution of derivatives transactions. Under the CFTC rule, swaps dealers would have to request bids from at least five market participants. Under the SEC rule, dealers might be required to solicit fewer – possibly as few as one – as is now the practice.

"This is a problem for people who are swaps dealers," Taft warns.

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NEW MONEY

TAKING A LOOK AT
THE POST-QE2 WORLD

BY JOHN SILVIA

As the markets anticipated an end to quantitative easing, the consensus expectation was that the pace of U.S. economic growth would pick up and inflation would remain quiescent. Things did not work out as planned.

In recent months the small improvement in employment signaled a lack of forward momentum in the economy. This was confirmed by the release of disappointing second-quarter 2011 Gross Domestic Product compounded by a jump in the annualized rise in the core personal consumption deflator above the perceived two percent Federal Reserve target rate. Meanwhile, the debt ceiling compromise appeared to fall short of expectations and was followed by Standard & Poor's downgrading of U.S. debt. For investors and traders, the environment has become uncomfortable at best, highly risky at worst.

UPSETTING THE POLICY FRAMEWORK

Since the mid-1970s, the actions of the Federal Reserve were framed within a traditional monetary policy framework that appeared to work quite successfully until the Great Recession. Fed actions would start with a change in its benchmark short-term interest rate, the federal funds rate, which would alter market interest rates and lead to changes in economic activity.

Since 2008, however, the Federal Reserve first lowered the federal funds rate down to 25 basis points or so and then the Fed turned to quantitative easing that effectively increased the size of its balance sheet. This was intended to provide the private banks with additional reserves whereby these institutions would be able to increase their lending to private firms.

Easier monetary policy, which tends to lower market interest rates in the short run, thereby reduces the cost of capital for many possible investments that would have an expected rate of return above that now lower interest rate and thereby these investments would now appear to be profitable.

Unfortunately, two major problems showed up along the way, affecting both the demand and supply of credit. On the demand side, credit demand did not respond to the lower interest rates as much as was expected. The recession had lowered the expected pace of growth in the economy and particularly in what were considered interest rate sensitive sectors such as consumer durable goods and housing.

The lower expected rate of growth of the economy meant a lower expected pace of top-line sales for any company, and with business confidence low, especially in the small business sector, the expected rate of

return on any investment fell. Therefore, despite the lower level of interest rates in general, the lower expected returns on investment reduced the demand for credit and thereby the ability of policy generated lower interest rates to generate economic growth.

The recent lower GDP growth rate and its revisions have altered the expected future growth rates and interest rate patterns in the United States.

On the supply side for credit, lenders had just experienced a period of rapidly rising delinquencies on creditor payments and were also facing the same economic uncertainties as borrowers. Therefore, when presented with new reserves from the Fed's easier monetary policy, lenders held a much larger than usual portion of those reserves as excess reserves—higher reserves than needed to support the current level of lending.

So why would lenders retain excess reserves/liquidity and not lend to the maximum? Pervasive uncertainty is the answer. There is uncertainty with respect to the quality of past lending due to losses on the loan portfolio as well as high levels of delinquencies across the board. There is also uncertainty about the returns on future lending given the disappointing pace of expected future economic growth. Lower economic expectations mean a lower expected rate of return on any loans from the viewpoint of the lender.

Meanwhile, the experience of recent years has led to a heightened level of financial regulation in the United States after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. While the details of the regulation remain to be defined by the regulators, the direction is expected to be toward higher, more restrictive regulation. This domestic shift toward higher regulation is reinforced by the pursuit

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of higher capital standards as well as other moves to increase regulatory oversight under Basel II and eventually Basel III as well. This higher level of regulatory oversight at the global level leads into our next major issue.

GLOBALIZATION ALTERS THE FINANCIAL MARKETPLACE IN UNFORESEEN WAYS

Over the last 30 years, the coincident emergence of increasing cross-border financial flows and greater imbalances in those flows between major countries have raised the prospect that small changes to market expectations would lead to larger changes in market pricing of credit, financial assets and economic growth expectations for any given shock in the global market system.

Two aspects of the globalization have altered the traditional paths from policy actions to economic results. First, the role of forward-looking expectations became paramount. Exchange rate markets have become unhinged from the Bretton Woods system and aware of the inflation history of the 1970s adopted a more forward looking view of policy implications. Second, without a fixed exchange rate regime, growth, inflation and interest rates each had its own influence on the exchange rate for

Therefore, when presented with new reserves from the Fed's easier monetary policy, lenders held a much larger than usual portion of those reserves as excess reserves

each country. As market trading became a 24-hour phenomenon, the implications of changes in the perception of Chinese/Japanese growth rates, inflation in South America and changes in interest rates across Australia, India and the Euro community all had significant implications for financial markets. So too have policy actions, as any given change in fiscal and monetary policy would have a very different impact in an open economy than a more closed one.

Yet, the U.S. dollar reaction to relative interest rates and the growth of financial movements has also grown over the years. In recent months, we have seen a surprise, to some, appreciation of emerging market currencies, such as the Brazilian real, versus the U.S. dollar, while the Chinese yuan has also moved upward under the managed exchange rate system adopted there.

Risk is very prevalent in the financial sector. The United States has become a significant capital importer today relative to an earlier age, and those imports come from a very small group of lenders, primarily Japan and China. As a result, there is a growing perception that the United States is dependent on capital flows from abroad. That dependency cre-

ates a heightened sensitivity to changes in expectations around growth and interest rates abroad, as well as to political risk.

In markets, uncertainty on the flow of credit creates volatility in prices for such assets as gold, farm land, currencies and strategic commodities. In the last six months this dependency and its implications have been escalated given the problems on the real side of the economy. Uncertainty is reflected in both the amount and direction of financial flows and thereby the sharp changes in asset prices.

Moreover, with the integrated currency and credit markets, changes in monetary/fiscal policy in national markets are not generating the growth/credit easing that had been expected. Instead, additional monetary liquidity has flowed to commodities and higher inflation in emerging markets, notably China, at a rate faster than some policymakers feel is comfortable.

PERVASIVE IMPACTS ACROSS ALL FINANCIAL MARKETS

Surprises in the impact of additional global liquidity reinforce the impression that any actions by the public or private sectors will have pervasive impacts in areas of the global economy that we do not associate with any given action. For example, the downgrade of U.S. Treasury debt was not enough to get investors to shy away from Treasuries. Instead, investors sold equities and, for risk-weighted fixed-income portfolios, investors shied away from lower-rate, investment-grade credits so that the average rating of the portfolio would remain the same.

Integration of the capital markets has reinforced the need for investors and traders to be aware of the hidden, implicit, assumptions we all make when we put in place our investment strategies. In some ways, this is reminiscent of the assumptions of liquidity and marketability that were made prior to the 2008 recession. On the usual path, the reaction of equity prices to lower economic growth expectations following the release of the revised GDP data was not surprising. Lower growth would suggest lower corporate profits/earnings and thereby less willingness to pay up for equity ownership. Yet, beyond that, the uncertainty on the quality of credit in the Eurozone is also having an impact on U.S. equity prices in a way that would not have been expected years ago.

This impact reinforces our need as investors and decision makers to revise our framework for examining markets. Too often the tendency is still to think in linear terms—i.e., increased federal spending leads to increased growth—without taking into consideration the negative feedback effect that higher spending might suggest larger future debt burdens that an increasingly skeptical global investor is likely not to accept that higher debt without the price of higher interest rates and/or a weaker U.S. dollar. The pervasiveness of impacts of any change in one set of actions in one country upon a host of other countries is one of the distinguishing factors in our 21st century economic system.

John Silvia is a managing director and chief economist for Wells Fargo. Prior to his current position, Silvia was chief economist for the U.S. Senate Banking, Housing and Urban Affairs Committee. In 2010, Silvia was recognized by the Federal Reserve Bank of Chicago for the best inflation forecast, the best overall forecast and the best personal consumption expenditures forecast.



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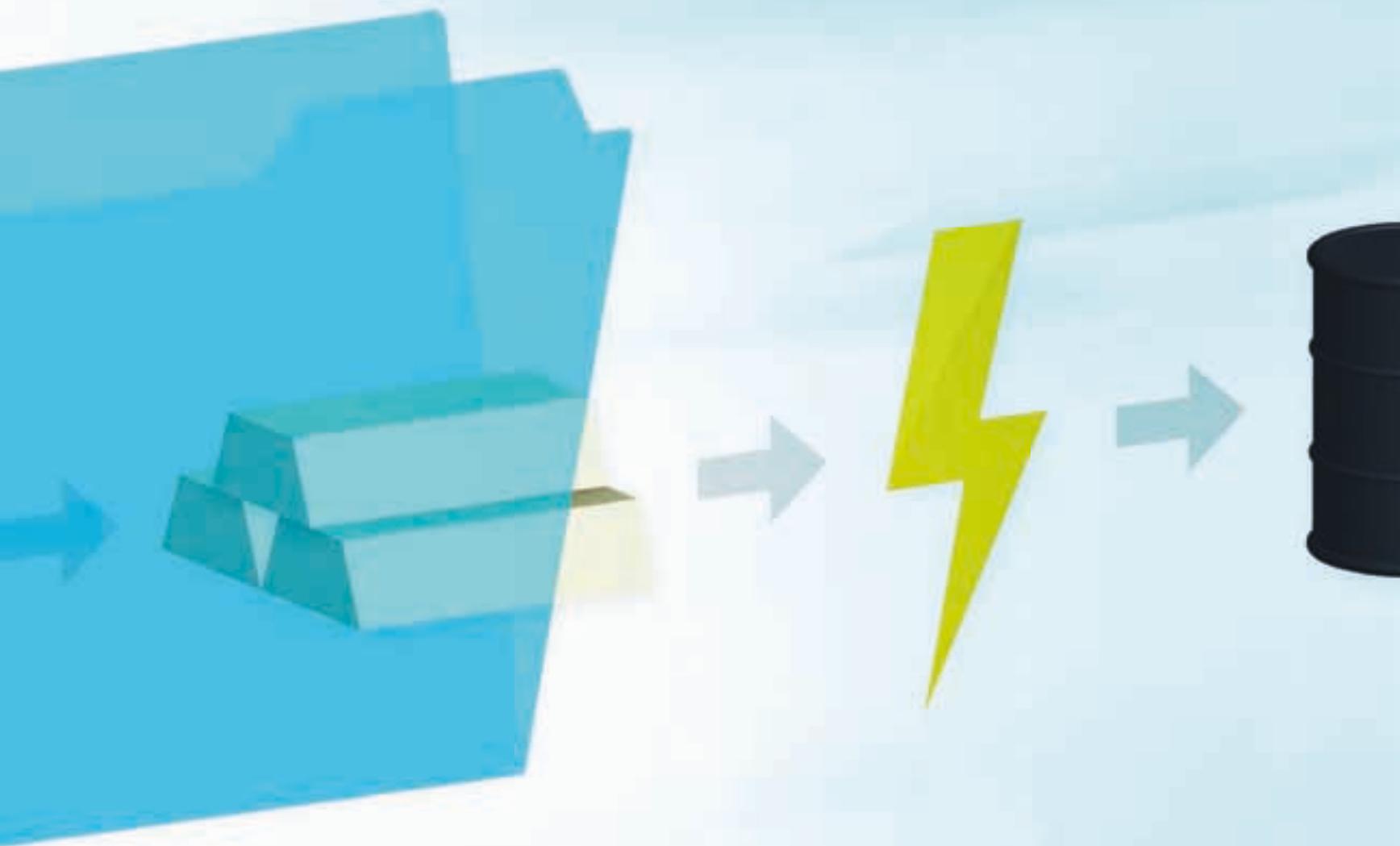
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CLEAR BENEFITS



**What the Globalization of Clearing
Means to the OTC Market**

The legislative drive to regulate over-the-counter derivatives continues on both sides of the Atlantic. A unified directive is still looking hazy as regulators move toward deadlines for new standards.



Regulation seeking to overhaul the \$600 trillion over-the-counter (OTC) market is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the mammoth piece of U.S. legislation drawn up in response to the financial crisis of 2008. Similar, but not identical, regulatory structures are being drawn up by the European Union (EU), which will affect OTC markets across Europe.

The undertaking is daunting, as it ushers in “a new era of trading styles and protocol based on new platforms,” says Andy Nybo, principal and head of derivatives research at TABB Group, a research and consulting firm.

“It’s a huge endeavor to transform the industry,” including transitioning certain parts of the OTC marketplace that are still voice-executed to electronic trading, he notes.

“We are definitely trying to push this process forward,” says Andrew Sterry, European head of derivatives intermediation and derivatives clearing at Citi Prime Finance, and a CME clearing client on both sides of the Atlantic. “But people are seeking clarity on the rules,” he adds.

Hanging over the unclear picture in the U.S. and Europe is the possibility that market participants could shift OTC activity to growing Asian markets because of their friendlier regulatory policy, a process known as regulatory arbitrage.

One point that is clear is the Dodd-Frank requirement that standardized swaps must be cleared and guaranteed by clearinghouses and traded on either an electronic exchange or swap-execution facility (SEF). The rule seeks to give the market greater transparency and mitigate concerns about mutual credit risk between trading counterparties.

Certain aspects of the proposed legislation “will absolutely improve the current marketplace,” Nybo says.

In a study released in July 2011, the TABB Group said central counterparty clearing (CCP) services “will change the counterparty risk equation...CCPs don’t remove counterparty risk, but they do strongly mitigate it. More important, when a trade is cleared it no longer matters who’s on the other side of the trade – the CCP is the buyer to every seller and the seller to every buyer.”

The cry for clearing

The broad global agenda that is changing the OTC landscape was set in motion in September 2009 at a meeting of the G-20 industrialized nations

in Pittsburgh, held one year after the failure of Lehman Brothers Holdings. The G-20 agreement called for standardized OTC derivative contracts to be traded on exchanges or electronic trading platforms and cleared through central counterparties by the end of 2012 at the latest.

In addition, the G-20 said OTC derivative contracts should be reported to trade repositories and that noncentrally cleared contracts be subjected to higher capital requirements.

Clearinghouses around the world are now gearing up for their expanded role in OTC markets.

➔ **Rate products in particular will benefit from centralized OTC clearing**

Andrew Sterry, European head of derivatives intermediation & derivatives clearing at Citi Prime Finance

CME Group has transferred its experience in clearing exchange-traded financial derivatives to include clearing of OTC financial products, such as credit and interest-rate swaps in the United States. Now it is looking to do the same in Europe through CME Clearing Europe. Launched in May 2011, CME Clearing Europe currently clears energy, agricultural and freight products, and plans to clear interest-rate swaps and credit default swaps.

Interest rate contracts represent the largest OTC market segment, with a notional value of \$465 trillion as of December 2010, according to the Bank of International Settlements. Credit-default swaps (CDS) logged a notional value of nearly \$30 trillion in December 2010.

“Rate products in particular will benefit from centralized OTC clearing, as they will be listed on the same venue,” says Sterry.



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Location, location, location

Andrew Lamb, chief executive officer, CME Clearing Europe, notes that London is a gateway to Europe because it is home to a large community of international banks and nonbank financial firms, hedge funds and institutional investors. In addition, clearing in London may offer a geographic advantage for certain derivatives products, particularly during this period, when uncertainty over the final rules has added a layer of complexity to market dealings.

In addition, "European clients want to stay within the European framework," adds Sterry.

The European Market Infrastructure Regulation (EMIR) is still in draft form, and is "quite compact" compared with the Dodd-Frank legislation, says Lamb. "Generally speaking, the EU process—called the definition of standards—is quite a bit behind the more ambitious timetable set in the United States," he adds.

"The obvious difference between the United States and the EU is that change at the EU level involves discussions between 27 member countries, many of which have very small financial services sectors and little by way of experience with OTC derivatives markets," Lamb explains.

→ **Clearing accounts are now being set up, swap execution facility aggregators designed, and trading strategies examined.**

Ready, set, clear

Despite regulatory delays on both continents, "clearing accounts are now being set up, swap execution facility aggregators designed, and trading strategies examined," the TABB Group notes in its study, "Higher Frequency Swaps Trading: Market Making and Arbitrage." The report suggests the ongoing OTC derivatives reform is "setting the stage for some long-overdue market innovation."

Nybo says once the legislative landscape is finalized, the marketplace will quickly embrace central clearing for swaps. Vendors are currently building out platforms in anticipation of final rules and already have invested in solutions to support standardized swaps, he says.

There is, however, some ongoing debate about some of the regulations proposed as a result of Dodd-Frank. One proposed rule would

require that 85 percent or greater of the total volume of any contract listed on a designated contract market (DCM) be traded on the DCM's centralized market, as calculated over a 12 month period. Some in the clearing industry, including CME Group, have opposed this proposal as an arbitrary one not required by Dodd-Frank.

Another rule under debate between clearing firms and the U.S. Commodities Futures Trading Commission (CFTC) is the proposal for a "complete legal segregation model," where the open positions and collateral of cleared swaps customers would be comingled on an operational level. However, in the event of a default in a customer's cleared swaps customer account, a derivatives clearing organization would be permitted to access the collateral of non-defaulting customers in order to cure the default.

Then there is the question of whether OTC clearing will add liquidity as well as transparency to the market. "Central clearing is part and parcel of futures markets and is generally accepted as a key factor behind the liquidity that is so notable, particularly in benchmark products," says Lamb. "Open interest in CME Group's interest rate products stand out in that regard."

Similar to futures trading practices, an OTC order under the reformed OTC structure order might begin with a client, move to a broker-dealer, then to a SEF, before ending at a CCP.

Credit-default swaps were under particular scrutiny by regulators, as both the failed Lehman Brothers and American International Group Inc. (AIG), bailed out by the U.S. government in an \$85 billion deal, were active CDS traders.

Expressing the regulators' view, CFTC Chairman Gary Gensler told an industry conference last spring that "the financial crisis demonstrated the risk to the public of ineffectively regulated swap dealers."

"While banks and securities firms were regulated by their prudential regulators, their affiliates that traded swaps often were left ineffectively regulated—that was the case for Lehman Brothers and AIG," Gensler said.

"The industry is not sitting around twiddling its thumbs" while regulators fine-tune the process, Nybo says, "but there are roadblocks and challenges. Not the least of those challenges is the lack of regulator harmony in Europe and the U.S."

"Accommodations will be made," concludes Nybo, "but I do not expect the same set of regulations will be used in the U.S., the U.K. and Europe."



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IN 2010, THE ASIA-PACIFIC derivatives market became the world's largest, with 8.9 billion contracts traded, a 43 percent increase over 2010. Though South Korea, China and India accounted for much of this volume, Bursa Malaysia Derivative Berhad, located in Kuala Lumpur, is also pulling its weight. According to the Futures Industry Association, in 2010, average daily volumes (ADV) at Bursa Malaysia stood at 25,000 contracts. By July 2011, ADV had grown 40 percent to 34,000 contracts.

Much of this increase can be attributed to a strategic partnership Bursa Malaysia formed in 2009 with CME Group. In joining forces, the two exchange operators hope to grow the Malaysia derivatives market by making Crude Palm Oil Futures (FCPO) contracts available through CME Globex, the global electronic trading platform. "We have seen market volume go up since we introduced products on CME Globex," says

brokers' Association, the first formal securities business in what was known then as the Malayan Union, a British Crown Colony. In 1960, this organization evolved into the Malayan Stock Exchange and, in 1964, a newly independent Malaysia saw the establishment of The Stock Exchange of Malaysia, which, in 1973, split into two entities several years after Singapore's secession. In April 2004, a final name change marked the global debut of Bursa Malaysia Berhad, a fully integrated exchange offering a complete range of investor services and Sharia-compliant products, among them futures trading in palm oil.

Perhaps no other global commodity is as ubiquitous as palm oil, with roughly 180 million tons produced each year. "If you went into your local supermarket, something like 40 percent of the products on the shelves have some element of palm oil in them," says Millar. Palm oil is used

global interest reached an all-time high of nearly 131,000 contracts on July 7, 2011, as palm oil producers hedged against the softening of palm oil prices in the cash market.

From CME Group's perspective, numbers like these validate a forward-thinking global strategy. "There has been a basic shift in economic tail winds in the last few years from the west to the east," Millar says. "CME Group realized that to be truly representative of where we fit in the global economy we needed to expand our presence in Asia. Having the preeminent regional player in the crude palm oil futures on CME Globex is an important part our strategy for success."

Going forward, Bursa Malaysia and CME Group hope to build upon their recent successes in futures trading. "In Malaysia, our partnership has very good synergy," Millar says. "We plan to help Bursa Malaysia devel-



Bursa Malaysia Berhad has emerged as one of the rising stars of the Asia-Pacific derivatives market. Now the exchange is setting its sights beyond its home market.

Dato Tajuddin Atan, Bursa Malaysia Berhad chief executive officer and chairman of Bursa Malaysia Derivatives Berhad. "Since September 2010, the volume of trades in crude palm oil futures has increased by 17 percent, and we are very encouraged by this."

According to Phil Millar, director of alliance venture management at CME Group, making FCPO contracts available globally actually helped meet pent-up demand among investors. "You have to remember that palm oil is among the most heavily used commodities in the world," he says. "There has always been demand for FCPOs, but limited accessibility made trading in this specific product more difficult. Our partnership with Bursa Malaysia lowers those barriers for entry into the market."

Bursa Malaysia's association with palm oil predates the explosive growth of the Asia-Pacific derivatives market.

In 1930, several bankers in Kuala Lumpur and Singapore founded the Singapore Stock

in cooking, as an industrial lubricant, a food additive, in detergents and soaps and in biodiesel. Until 2009, Malaysia was the leading producer of palm oil—it now claims second place behind Indonesia. Consequently, Bursa Malaysia is the global center for crude palm oil futures.

Bursa Malaysia's 2009 decision to partner with CME Group to meet ever-increasing global demand for palm oil futures marks the latest, and perhaps most dramatic, reinvention. "By September 2010, we had successfully migrated all of our trading data onto the CME Globex trading platform," Atan says. "This was an exciting event because we could suddenly leverage this truly global platform to achieve over one million access points. It also gives us access to a highly liquid market and to global distribution channels."

According to Atan, the partnership has already proven fruitful. In the first half of 2011, derivatives trading revenue is up 45 percent over the same period last year. Furthermore,

op its markets and put more of its products on CME Globex." Additionally, Bursa Malaysia plans to broaden its FCPO, and support the creation of hedge and commodity funds and more domestic funds.

Most important, though, the two groups plan to undertake an educational campaign to raise awareness of what Atan calls Bursa Malaysia's "jewel in the crown," its FCPO contract. Through seminars and other forms of educational outreach, this year the partners hope to educate 400 domestic and international customers on the unique value proposition of crude palm oil futures and on Bursa Malaysia's emerging prominence in the Asian-Pacific derivatives market. "This is a very promising partnership," Millar says. "Bursa Malaysia has the local expertise, and CME Group has global expertise. Together, we really complement each other."



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TRADE NO 0039841

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TRADE NO 0022441

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TRADE NO 0033692

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WHAT HIGH-FREQUENCY TRADERS REALLY BRING TO THE MARKET

High-frequency trading is changing the markets as much as any of the myriad of regulatory and economic changes that are underway. This is changing liquidity and trading strategies for the increasing number of firms that employ it.

High-frequency trading (HFT)—sometimes colloquially called “hi-freq”—is the automated trading that takes place when sophisticated computerized tools allow firms to trade stocks or options. And, as much as any of the numerous other regulatory, economic and technological changes taking place in futures markets today, high-frequency trading is changing the way that trading firms operate.

In the past several years, some pace-setting firms, such as Infinium Capital Management, are starting from the get-go trading in an automated environment. The Chicago-based trading firm was founded in 2001 “with the mission to pioneer electronic trading of exchange-listed options and futures as the market evolved toward screen-based trading,” according to Aaron Lebovitz, a principal of Infinium. “We began trading in automated fashion once our platform was built in 2002.”

At its heart, high frequency allows for lower-latency trading, reducing the time it takes to execute a trade from minutes or seconds to microseconds, and allowing trading firms to place more short-term strategies, and ultimately “increasing the liquidity and arguably increasing the compression in spreads,” according to Sang Lee, managing director at Aite Group, a leading research firm for the financial services sector

Case in point: Infinium Capital utilizes a combination of human and automated trading, depending upon the issue, according to Lebovitz. “The types of activities we have invested in automation involve the simpler products, such as futures and vanilla option structures,” he says. “We currently do, and will continue to, integrate those electronic trades with our activities in more complex or less liquid products such as deferred futures expirations and complex option structures.”

While this technology favors more liquid issues, as Lee points out, smaller, more tech-savvy shops can benefit from high-frequency trading, even in the short run.

“I think it’s made the market more competitive,” says Lee. “Smaller firms that make the technology investment can effectively compete against larger firms. It’s leveled the playing field.”

The usage of high frequency, by most accounts, is snowballing. For example, automated trades accounted for almost two-thirds of CME Group foreign-exchange futures volume in the second quarter of 2011.

Since implementing an HFT system can be expensive – costing upwards of “hundreds of thousands of dollars,” says Lee – Lee believes that it is unlikely that high-frequency trading would ever be employed by all trading desks. Investment firms that deal in less liquid equities, or that employ more of a buy-and-hold strategy, he says, may feel little need to sink the money into this technology.

PART OF A BROADER CHANGE

Ultimately, it is not high-frequency trading in isolation that is shaping the equities market. High-frequency trading is having a more profound effect because it is working in tandem with other on-going regulatory and technological factors that are also enhancing liquidity and a greater emphasis on speed and narrowed spreads across asset classes, according to Lee. Cases in point: The introduction in recent years of the FIX protocol, a standard for expressing algorithmic orders used by virtually all broker-dealers as well as banks and funds and institutional investors; and the growing popularity of co-location services that allow trading firms to place multiple data centers close to trading centers.

“It would be tough to argue that we’ve ended up where we are just because of high-frequency trading,” Lee notes. “In the end, all these factors reinforce each other.”

Nonetheless, Lebovitz believes that high frequency is contributing to making the markets more stable, transparent and efficient. “We believe that all of our market making activities reduce market volatility and reduce customer trading costs by adding to the depth of markets, by increasing transparency of prices, and by tightening bid/offer spreads,” he says.

A recent study commissioned by the British government’s Office for Science supports Lebovitz’s view. In its study of the HFT impact on liquidity, transaction costs and price discovery, it found that “overall, liquidity has improved, transaction costs are lower and market efficiency has not been harmed by computerised trading in regular market conditions.”

And high-frequency usage is broadening throughout the trading world, as well as deepening in various sectors. “There are hedge funds that are quietly launching high-frequency desks,” Lee says. “As the market continues to mature, you’ll see more of a framework of controls around high-frequency trading.” Indeed, he says that the next group to embrace high-frequency trading may not be the small trading firms, looking to gain advantage on their larger counterparts, but may in fact be the larger and more traditional trading firms as well.

Infinium, like other trading firms, has taken several steps to ensure that high-frequency trading does not create a more turbulent market, according to Lebovitz. The firm works closely with both industry organization and with regulatory agencies to develop guidelines and detailed best practices for firms that engage in automated trading. They have also adopted “a philosophy of ‘multiple, redundant checks,’ whereby our individual trading algorithms each have bespoke monitoring of their activities to provide the most targeted protections,” he says.

For example, Lebovitz says that many of Infinium’s algorithms will shut themselves down if they trade at a price significantly different from the order price, because that would indicate that the algorithm may have

miscalculated where the market is currently trading. The redundant checks are introduced outside of the individual strategies, where the firm has software components that monitor messaging and fill patterns of individual algorithms out of band (in separate applications residing on separate hardware). He adds that the firm has several of these types of checks to address any identified points of failure in the system.

CO-LOCATION

Like high-frequency trading, co-location has boosted trading firms’ abilities to reduce latency and trade faster and more efficiently than ever before.

Co-location centers, with data servers installed much closer to the physical site of the market, allow trading firms around the globe to further fulfill their need for speed. As Sang Lee of Aite Group points out, “a trading shop in Idaho may suffer a few seconds latency in getting information from someone on the floor in Chicago or New York.” Using a combination of co-located servers and high-frequency trading, “any potential disadvantage is removed,” says Lee.

Indeed, many co-location sites are located in the same building as the matching servers to which they need to communicate. In early 2012, CME Group will launch its own co-location service, offering a low-latency connection through a co-location data center facility, which will house trading match engines for all the products traded on the CME Globex platform.

While not yet offering specifics, Lebovitz of Infinium states the case succinctly when he says, “We are strong proponents of co-location services to increase efficiency and transparency in markets.”

In the case of the infamous ‘flash crash,’ Lebovitz points out, “Infinium did continue to provide liquidity in many of the products we trade all the way through the volatility. I think that our activity along with that of many other automated trading firms contributed to the stabilization and ultimate rebound of the market that day, quite the contrary to adding to the turbulence.”

In the end, Lee believes that the need for speed will continue to drive forward markets and the technology that supports trading. More regulatory rules that move the equities market toward “greater transparency” – including better reporting of dark pools, or more consolidated audit trails – are likely to follow, he believes. But, he adds, “Arguing whether high-frequency trading is good or bad is a futile exercise. It’s here.”

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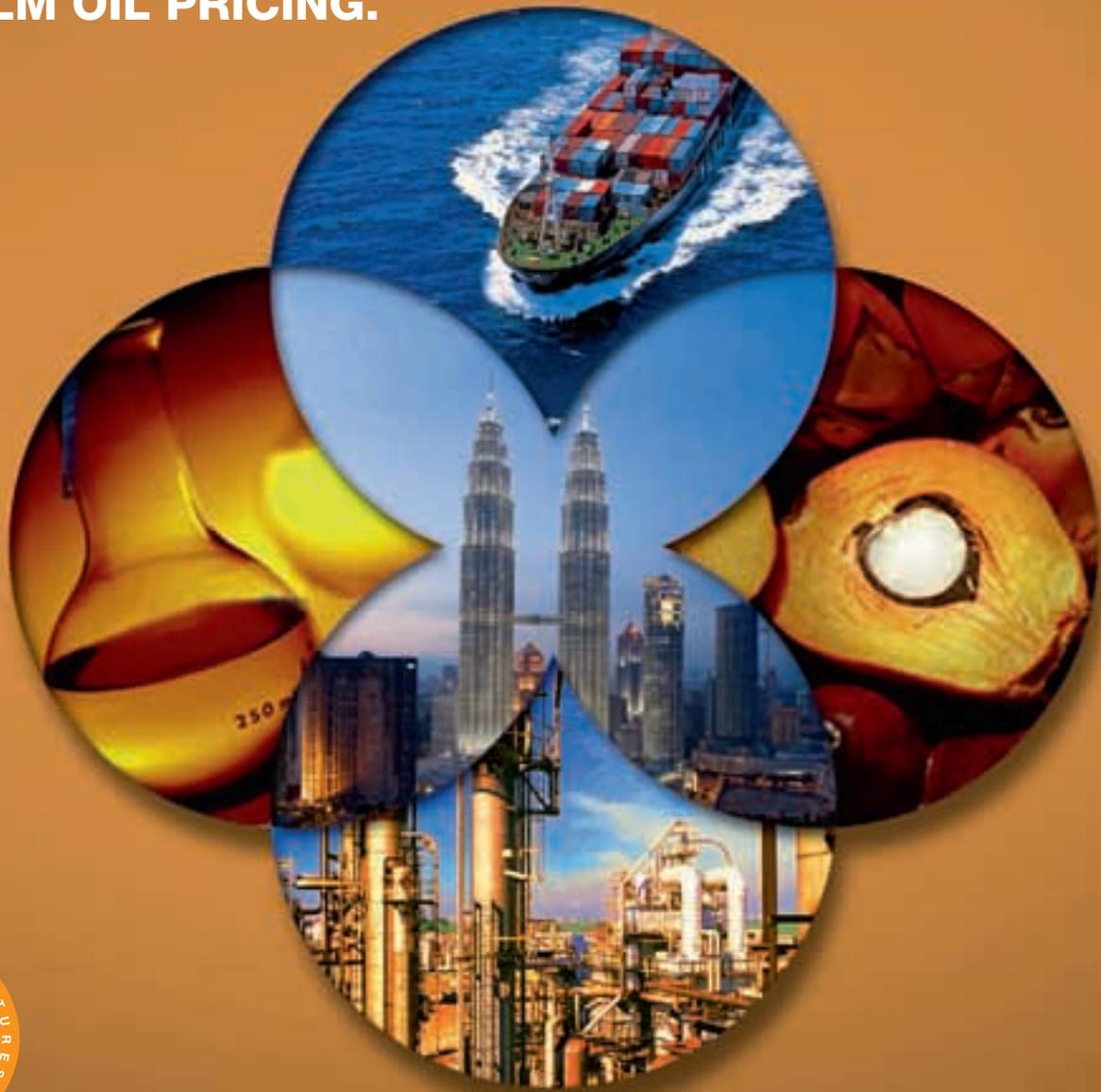
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A new format for the world ahead.

CME Group Magazine will begin delivering our in-depth content on global trends in the derivatives industry on a more timely basis. In 2012, the magazine will merge with the CME Group blog and be re-named *OpenMarkets*. Our new online-only format will enable us to deliver content in a more immediate and environmentally conscious way, while providing readers a forum for conversation about ideas shaping the industry.

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OPENING UKRAINE'S MARKETS TO THE WORLD

→ On May 26, 2011, CME Group announced it executed two historic memorandums of understanding, one with the government of Ukraine and the National Bank of Ukraine, and another with the commodities exchange, Ukrainian Futures Exchange, to look for opportunities to further develop the financial and derivatives market in Ukraine for grain and non-agricultural products. *CME Group Magazine* spoke with Leo Melamed, chairman emeritus of CME Group, who led the Ukraine project, about what the outcome of this relationship could mean for global commodities markets.

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How the world advances

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Q&A with CME Group Chairman Emeritus Leo Melamed

Q What is the significance of these relationships in the Ukraine?

A First, the two memorandums of understanding (MOUs) with the government of Ukraine, its central bank and the Ukrainian Futures Exchange (UFE) represent an important step by CME Group to establish our presence in Eastern Europe. This is another example of how we are executing our growth strategy by providing our expertise and capabilities globally in Europe, Asia, the Middle East and Latin America. As the world's demand for agricultural markets continues to grow, Ukraine plays a key role in grain production with nearly 30 million hectares of arable land. Companies needing to hedge their commodity risk will be able to benefit for the first time from a set of standards established for Ukrainian wheat and knowing they will have the reliability of delivery.

Q What was the reaction by the Ukrainian government when you first approached them about working together?

A When I met with and spoke with Ukraine President Viktor Yanukovich and the Minister of Agriculture and Food Stuffs Mykola Pryshchynuk, they enthusiastically expressed their interests as being an economic leader in Eastern Europe. Since his election in 2010, President Yanukovich has had a vision for more free trade, and developing the domestic financial markets is a goal of his in order to open up the nation's economy to other parts of the world. Both of them understand that risk management of commodities is important to reaching this goal and expressed to me their willingness to work together with us.

Q Why did you pursue this partnership in the Ukraine?

A I actually pursued an initiative in Russia as well as in the Ukraine. Both countries are major growers of wheat. In the Ukraine, I had a longstanding relationship with a former official, Leonid Kozachenko, who was immensely helpful in advancing the Ukraine connection.

Not only is Ukraine the world's sixth-largest exporter of wheat, but the country also hopes to join the European Union. They have high ambitions to be a key economic force in the region. As businesses such as farming, food production and even biodiesel need to meet the rapidly rising demand from both established and emerging economies, they must be able to hedge their risk from weather and other economic factors. As we were talking with market participants about this project, we received very positive feedback that this was a move in the right direction for global food markets.

Q What is next for working together?

A In the next six to 12 months, we will be developing and launching a new futures market based on Ukraine's Black Sea wheat market. During this time, we will be talking through many of the key details with our new Ukrainian partners, including market regulations, contract specifications and delivery. By listing this contract on our world leading electronic platform, CME Globex, we will be able to immediately let the world manage their risk in this region and help President Yanukovich get another step closer to his vision.



A Global Perspective



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CURRENT PULSE



Access to Mexican Markets

CME Group and the Mexican Derivatives Exchange (MexDer), the second largest exchange in Latin America, have successfully launched their north-to-south order routing agreement, giving U.S. customers access to benchmark derivatives contracts including Mexican Stock Exchange Index futures, bond futures and MXN Peso/U.S. Dollar futures contracts. The first phase of the agreement went live earlier in 2011, and gave Mexican investors access to CME Group's benchmark derivatives contracts covering interest rates, foreign exchange, equity indexes, energy, metals and agricultural commodities.

"Mexico is the 13th largest economy in the world, and we continue to look for opportunities to provide our customers around the world with the broadest and most diverse range of globally-relevant products to help them manage their risk," says Phupinder Gill, CME Group president. "This next phase of the partnership demonstrates how we continue to build on our successful track record of growing our business internationally through strategic partnerships."

For more information, including a video featuring Jorge Alegria, MexDer chief executive officer, and David Shuler, CME Group managing director of alliance and venture management, visit www.cmegroup.com/mexder.

Simulating Energy Trading

In conjunction with CME Group, Tulane University and the Energy Management Institute are offering a new series of commercial energy training courses in fall 2011. These two-day courses will cover everything from fundamental analysis to advanced trading strategies and include real-time strategy simulations. The courses will be product specific and are tailored to the needs of natural gas, oil and power traders. They will be held at the trading lab at Tulane's A. B. Freeman School of Business, and at the Trading Knowledge Center located in CME Group's Chicago Board of Trade building.



GROWING GLOBAL LEADERSHIP

CME Group recently announced the additions of several key members to its global leadership team. They are Julien Le Noble, who was named head of the Asia-Pacific office in Singapore; Sean Tully, who was named managing director of interest rate products; and Michael Kilgallen, who will take over as managing director of equity products.

Le Noble previously served as chief executive officer and representative director, Japan and head of equities, Asia Pacific for Newedge, where he led the firm's Japanese business development and sales efforts for its Tokyo-based subsidiary.

Tully most recently served as managing director, global head of credit and fixed income trading at West LB in London. He also traded interest rate derivatives at Citibank and Greenwich Capital, running a global team in the interest rate swap business, and as a proprietary trader.

Kilgallen most recently served as managing director, global prime finance for Citigroup's equities division. He also worked as vice president, portfolio manager and co-head of trading for the quantitative equity group within Goldman Sachs & Co.'s investment management division.

Taking a Look at Commodities

The Dow Jones Indexes' 10th annual Mid-Year Commodities panel discussion took place at CME Group's Chicago Board of Trade building on July 13, 2011. Leading commodity experts gathered on the agriculture trading floor to discuss the commodities markets in the first half of 2011, while looking ahead to key macro themes with specific outlooks on the energy, grains and metals markets.

The topics and speakers included:

- **Mid-year Review of the Commodities Sector:** David Krein, senior director, product development & analytics, Dow Jones Indexes
- **Energy Outlook:** Phil Flynn, senior market analyst, PFGBest's Research
- **Grains Outlook:** Jack Scoville, vice president, Price Futures Group
- **Metals Outlook:** Patricia Cauley, director, metals products, CME Group
- **Trends in Commodity Index Investing:** John S. Kowalik, CFA, executive director, commodities structuring and marketing, UBS Securities LLC



American Business Awards

CME Group Magazine and the *OpenMarkets* thought leadership website were honored with American Business Stevie Awards for the Best Magazine and the Best Financial Services Website/Blog for 2011.

The Stevie Awards were created in 2002 to honor and generate public recognition of the achievements and positive contributions of organizations and business people worldwide. The American Business Awards are governed by a board of judges and advisors that features many of the leading figures in American business, and more than 200 executives nationwide participated in judging the competition.



A Great Place to Work

CME Group was selected by IDG's *Computerworld* as a Best Place to Work in IT for the seventh consecutive year. CME Group was among 100 top organizations honored for challenging their IT employees while providing great benefits and compensation, and is the only financial exchange company to receive the honor.

Some factors contributing to CME Group's recognition include the growth of electronic trading volumes, the CME Globex electronic trading system's speed and global reach, the new data center and co-location facility, and CME Group's partnership with BM&FBOVESPA to jointly develop a new multi-asset class electronic trading platform.

Computerworld is a bi-weekly IT publication, and the list was developed from the 18th annual Best Places to Work in IT survey, which was published in the June 20, 2011, issue and online at www.computerworld.com.

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