





**Neal Wolkoff,**  
CEO, ELX

Getco, Goldman Sachs, JPMorgan, Morgan Stanley, PEAK6 Breakwater and The Royal Bank of Scotland).

The ELX package contains several elements familiar from previous attempts on this market. There is the connection to the cash market via the involvement of bond brokerage BGC Partners and its eSpeed trading platform, both former subsidiaries of Cantor. Brokertec brought cash market synergies to the table too, along with a consortium of major dealers, which also went on to buy into Eurex US.

So, what does ELX have going for it that Cantor, Brokertec and Eurex didn't, and are its prospects for success any better than theirs? Recent years have seen a marked rise in futures trading volumes coming from high frequency trading firms, and signing some of them up as partners alongside the banks was a key strategy for ELX from the outset. "Probably the single overarching benefit that we've had over the past is that we're dealing in an electronic trading environment," says Wolkoff, "with an electronic ELX, an electronic CME and an electronic cash market". This, he explains, facilitates the participation of pricemaking firms making short term trades electroni-

### Defining success

Ironically, this change in the trading landscape was accelerated by Eurex US, whose competitive threat forced CBOT to fully embrace electronic trading. "In that particular case the competition brought about significant reductions in cost, improvements in speed, and greater responsiveness, so Eurex in a lot of respects was successful in bringing change to the market. Obviously, it wasn't successful in launching an on-going competitive exchange, but it did bring and accelerate change in the market, and I believe that to some extent we're the beneficiary of some of that change."

This point raises the question of what exactly success means for ELX, given that it is owned by a consortium of active trading firms that stand to benefit from fee reductions at CME. Is ELX a serious bid to create a viable exchange, or simply a lever with which to effect change at the incumbent? Wolkoff's position is that, with CME having become effectively the only financial futures exchange in the US, real and sustained competition is required. "I think that people realise that even if we effected change and simply disappeared from the scene as a result, there would be no real competitive forces to preserve that change."

In late 2007, driven by resurgent dissatisfaction with fees and growing unease at CME's de facto monopoly status, a consortium of 12 firms, including banks, market makers and a technology firm, announced their intention to establish a new exchange. Initially dubbed "project Four Seasons", the venture was to provide "a competitive alternative serving market participants", beginning with the launch of Treasury futures the following year. The name ELX - Electronic Liquidity Exchange - was coined in March 2008, but the initial launch timetable slipped as the exchange searched for a CEO.

cally across a number of different markets. "If on the one hand it's electronic and on the other it's somewhat electronic but more often than not involving infrastructure of a trading floor and a relationship, it's very difficult to build competition by using the available liquidity of market makers."

ELX has announced plans to increase competition by listing lookalikes of CME's flagship Eurodollar futures. With a launch target of Q2 next year, the timeframe for rolling out the new product is not particularly aggressive – a sign, according to Wolkoff, that ELX is a long term proposition. "It's an extremely high throughput

instrument, and we're developing with the expectation that we'll be successful, so we're not building it in a small way to try and get it out as fast as possible."

Whether or not the investors are in ELX for the long haul, in order to present a credible threat, the exchange needs to provide a genuine value proposition and attract meaningful volume. "Nobody trades and loses money and continues trading and losing money, it's just not that kind of a business whether you're invested or not, and so if we weren't providing a value proposition outside of being strategically important, I don't think we'd have reached the point of success that we're at so far."

facing the same problem as all start up exchanges. "There's a little bit of chicken and egg going on with needing to build open interest to attract open interest, and having to attract open interest to build open interest, but the fact is our open interest is heading in the right direction, and volume is going up." [NB: This interview was conducted before the availability of November trading figures, which showed a drop in average daily volume to 43,000. November market share was 1.9 per cent].

In the aftermath of the financial crisis, how long will ELX's backers be prepared to bankroll the exchange before seeing results? Wolkoff is understandably unwilling to

Probably the single overarching benefit that we've had over the past is that we're dealing in an electronic trading environment, with an electronic ELX, an electronic CME and an electronic cash market. This facilitates the participation of pricemaking firms making short term trades electronically across a number of different markets.

### Open interest

While volumes on ELX remain modest, they have been climbing, with October's average daily volume of 50,000 contracts representing a 30 per cent increase on the previous month. Wolkoff estimates that 20-25 per cent of that volume is coming from firms other than those with a direct investment in ELX. Overall market share in Treasuries has reached three per cent, with the shorter end of the curve – two- and five-year notes – achieving a five per cent share.

At present, says Wolkoff, the vast majority of activity on ELX is coming from market makers. "Generally what we're seeing is use of our market by price makers, much more so than price takers at this point. I think that's normal and to be expected given the stage that we're at." Consequently, he says, there is more liquidity in the market than the headline volume figures alone reveal: "there's a lot of size being bid and offered on ELX that isn't resulting ultimately in trades because we haven't yet brought in the underlying price taker." Doing so, says Wolkoff, is a priority, though he admits to

discuss what level of volume is required to break even, and how long ELX can afford to run before hitting that mark, but he does believe the investors remain committed. "Clearly they have other things on their plates; they're large firms and they're looking at other markets and other issues besides ELX, but they've been very supportive and attentive to what we're doing and they believe in the need for competition in the futures space. So to that extent I don't think the financial crisis has hurt us or diverted the investors' attention away from us."

Some of those investors seem at very least to be hedging their bets however, having recently signed up to buy stakes in NYSE Liffe US. That exchange's plan to launch rival Treasury futures cleared alongside cash Treasuries could spell the end of ELX, according to a letter to the Securities and Exchange Commission [see pp 14-5 in this issue].

### The F-word

While some external factors may spell danger to ELX, others, such as sweeping regulatory reform, may have a more

favourable effect. Fungibility – the ability to buy a contract on one exchange and sell at another – would enable market participants to move their open interest between exchanges without the fear of being unable to unwind their positions on an illiquid market. The vertical clearing model that dominates futures markets precludes this, and measures to bring in fungibility have been a source of perennial debate. Proponents point to the equity and equity options markets, where mandated fungibility promotes close competition between execution venues. Opponents argue that, unlike stocks, which are issued by companies, futures contracts are designed by the

the DoJ letter set out how the incumbent exchanges were able to starve the new entrants of liquidity by vigorously resisting their attempts to effect cross-margining between competing products, concluding that “exchange control over open interest and clearing have impeded entry and the development of meaningful competition in execution services”.

Much as that letter caused a stir, it was always destined to be overtaken by events, what with a change of President on the way and a deepening financial crisis giving regulators more pressing concerns than massive structural changes to one of the few areas

An overarching question is what exactly success means for ELX, given that it is owned by a consortium of active trading firms that stand to benefit from fee reductions at CME. Is ELX a serious bid to create a viable exchange, or simply a lever with which to effect change at the incumbent?

exchanges. Fungibility would, they say, reduce the ability of exchanges to profit from new product development and thereby remove much of the incentive to innovate.

The fungibility debate became more heated in January 2008 – shortly after the ELX consortium made their initial announcement – when the US Department of Justice called for a massive overhaul of vertical clearing arrangements. In a letter to the Treasury the DoJ recommended “a thorough review of futures clearing and its alternatives,” including the horizontal utility models used by the US equity and equity options industries, with fungibility of contracts listed on different exchanges. “In a world of fungible financial futures contracts, multiple exchanges could simultaneously attract liquidity in the same or similar futures contract, facilitating sustained head-to-head competition,” it said.

Using Brokertec and Eurex US as case studies, along with Liffe’s abortive attempt to poach CME’s Eurodollar contract,

of the financial services industry still functioning. Once the worst of the tumult was over, however, and the incoming Obama administration began looking into root and branch reform of the financial system, the fungibility pot was stirred again.

### **Harmonising regulatory regimes**

A June 2009 Treasury white paper called on the SEC and CFTC to identify “all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make recommendations for changes to statutes and regulations that would eliminate the differences.”

Public meetings were called in September to discuss various issues relating to the harmonisation of the two regimes, with figures from around the industry giving testimony.

Among those who called for a rethink of the futures clearing structure, with particular regard to fungibility, were former SEC Commissioner Annette Nazareth, and John Damgard, head of the Futures Industry Association, the trade body for futures commission merchants. ELX investor BGC Partners also spoke up, as did Wolkoff on behalf of ELX itself, saying: "the vertical integration of trading and clearing greatly reduces the incentive to provide competitive products and pricing."

Momentum appeared to be gathering, with many seeing CFTC chair Gary Gensler's call for OTC derivatives to be made fungible as a step toward an inevitable extension of that policy to futures. However, when the SEC and CFTC issued a joint report on

ready mechanism to be able to enter or exit the market as they saw fit."

That mechanism does, however, rely on both exchanges to play ball. And while Wolkoff maintains that the approval of ELX's EFF rule by the CFTC in October obligates CME to abide by it, CME unsurprisingly takes a different view, explicitly barring members from making EFF trades. This, claims ELX, is not only a breach of the CFTC approved rule, but also a misuse of CME's powers as a self-regulatory body, and hypocritical to boot, in that various similar transactions are permitted by CME already, with the only substantive difference being the element of competition. At time of writing, the vigorous debate is still ongoing, with little prospect of EFF

With prospects for full fungibility receding into the distance, ELX is pursuing an alternative way to facilitate the transfer of open interest between exchanges, via its exchange of futures for futures (EFF) rule. EFF transactions enable market participants to move positions from one clearinghouse to another by simultaneously buying and selling contracts from two different exchanges offering the same product. This provides a modicum of fungibility ...

harmonisation in October, they made no recommendation for change. The report was immediately hailed by CME Chairman Terry Duffy, who said it had "lifted a big regulatory cloud" from the industry.

### **Exchange of futures for futures**

With prospects for full fungibility receding into the distance, ELX is pursuing an alternative way to facilitate the transfer of open interest between exchanges, via its exchange of futures for futures (EFF) rule. EFF transactions enable market participants to move positions from one clearinghouse to another by simultaneously buying and selling contracts from two different exchanges offering the same product. This provides "a modicum of fungibility", says Wolkoff. "It's not complete, but it is a good position management tool for firms that are uncomfortable using a new market, but that would use a new market if they had a

transactions occurring unless CFTC explicitly compels CME to allow them.

So, is EFF the key to success for ELX? "The EFF would help to accelerate the growth and the recognition of ELX as a second pool of liquidity. I'd leave it at that. I wouldn't go as far as to label it a must have, [though]... clearly it would be a very good thing. It would help give confidence to would-be users of the market who are sitting on the sidelines waiting for an opening, and it would accelerate their use of the market."

Wolkoff insists that there is "no single issue that will make or break ELX". However, moves to achieve a degree of fungibility on the one hand, and the possible threat of a new competitor with a better mousetrap on the other, are likely to have a significant influence on the exchange's progress up the mountain in the next few months. ■