

# Value-added tracks

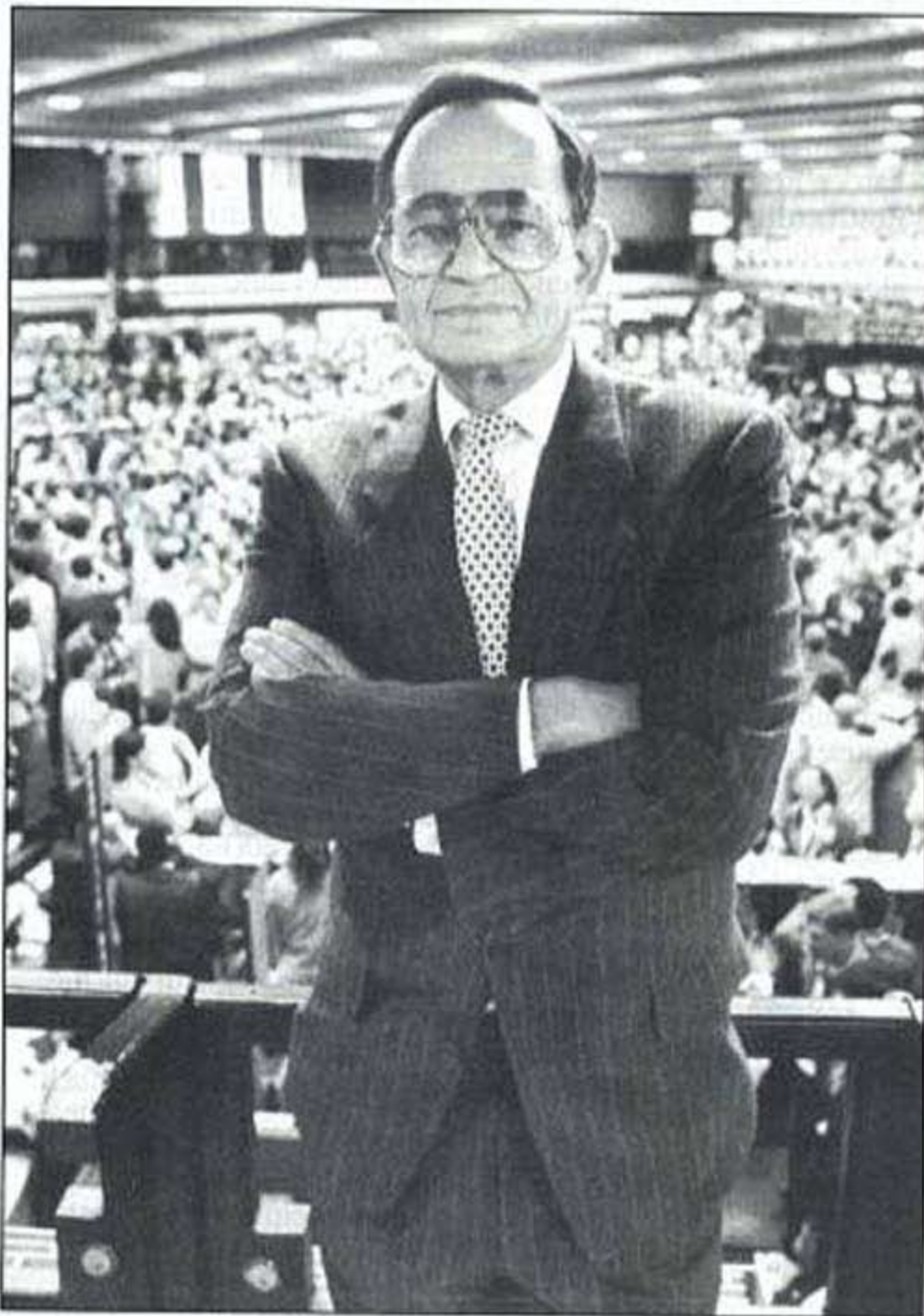
**There is nothing like an overdose of competition to bring out the creative side, as Adam Bradbery found out when he visited Chicago's clearing firms**

**L**ike many other sectors, futures clearing in the US has been undergoing a realignment over the past five or six years. Increasing competition and a growing number of players have put pressure on commissions and forced many operations to reassess their profit margins.

But with commissions finally reaching their floor, clearing operations have continued to structure value-added services to distinguish themselves from the competition. The past year has also seen far greater emphasis on merging the clearing and settlement operations for different markets into one central unit, thereby bringing substantial cost savings and operational efficiencies.

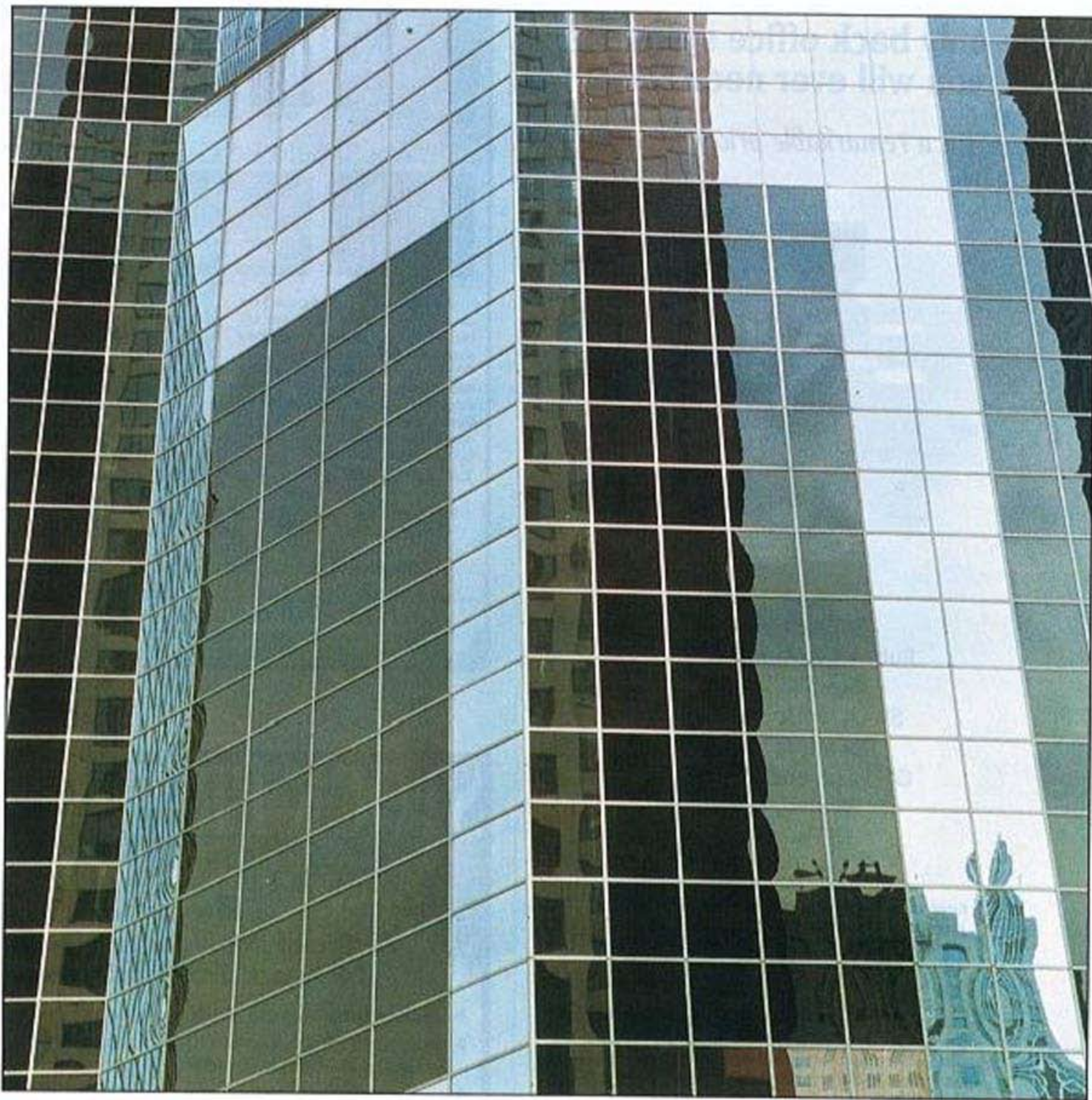
In Chicago, home to the world's largest futures markets, a global clearing service is still central to the ethos of many futures clearing firms. A large number believe such a service is crucial to surviving in the present market. "In order to compete on a worldwide institutional level you need to offer a full global clearing service, including book-keeping and daily reports from one central operations centre, stresses Quantum Financial Services' chairman Leslie Rosenthal. "Clients want one clearer across all markets rather than patching things together from a number of different people — it boils down to a better risk control system".

Ambitious to become a global player in the futures markets, Japanese bank Sakura structured a partnership with Chicago futures broker Dellsner. The US firm's owner Leo Melamed was happy to join up with the bank, which he believes had correctly judged the clearing market. "They said that to be a participant over the next decade or two, the bank would need to be a universal bank player and I liked their answer, so I decided I would build them a global FCM. Prior to that, Dellsner had no ambitions to be a global clearer because we were too small," comments Melamed.



*Melamed: happy to build Sakura a global FCM*





**Chicago: activity reflects the tougher business environment**

For Dellsher, the Japanese bank has opened up what Melamed sees as an underdeveloped business area in the Asian market. The bank's branch network, incorporating 670 offices in 31 countries, was also seen as crucial for providing outlets for Dellsher's derivatives operations. Melamed's aim is to use the spread of operations that Sakura possesses, including its securities, foreign exchange and swaps subsidiaries, to offer a full range of clearing services across the markets in which the bank already has expertise.

Sakura Dellsher is now looking to expand its clearing base by setting up operations in London and Tokyo early next year and intends to open a representative office in Hong Kong in the latter half of the year. The firm expects to develop its London presence pending the appointment of a marketing director in Chicago, who will need to liaise with any staff stationed in London. Melamed believes that in three years time Sakura Dellsher will be a "respectable name" in the global clearing market.

Rand Financial Services, one of the

top two or three volume clearers on the Chicago Mercantile Exchange and within the top 25 CBOT participants, realises that a global clearing service is essential to attract its desired target base. "We have to be a good global clearer to get the commodity trading advisors and overcome problems with time differences to locations such as Hong Kong," says Rand president Jeff Quinto. "We have endeavoured to be very good in the US to encourage business from CTAs which realise there is volatility in the markets but need access



to the markets". The vast majority of Rand's clearing customer base is made up of CTAs with large numbers of clients trading as pool operators. Its philosophy for attracting clients comes from the value it places on offering a personal Chicago service and the firm says it would not therefore set up its own US-staffed branch overseas.

Rand's *modus operandi*, according to Quinto, is slightly different to many other clearers. The firm tries to mould strategic alliances with other clearing firms in order to use their expertise in various markets. "We have developed deep relationships which entail more than simple clearing and have arranged lower rates with our clearers," he says. "Customers are looking for customised clearing on exotic types of products and they don't necessarily want just one global clearer".

Pressure on commissions has increased steadily as more players enter the market and existing ones become desperate to retain their foothold. Quinto comments, "Rates are very low these days and it definitely seems that people want market share and some are obviously trying to keep business flowing through. There is a thin band of commissions, but you cannot just offer low fees — you need a very good level of service and if the CTAs do not care for that, then you've lost them." Commissions have now hit rock bottom, according to most players, and the downward trend can continue no further.

Consolidation continues as the commission dollar is worn down to the bone. "We are not making enough return on our capital and we are going through a shake-out period at the moment," Rosenthal explains. "Eventually we will have no middle class of operation — there will be the smaller boutique type of operation with business transacted on a low capital basis and the larger balance sheet entities such as bank FCMs." In many cases, clearing firms say they have had to turn down business because commission demands are too low for their profit structure. "We are not going to match the rates just because we want the business," stresses Rosenthal.

In such a tough environment, some observers have suggested that banks are ideally positioned to offer their range of banking services to clients and sustain a gruelling commissions battle. Naturally, many of the traditional Chicago clearing firms deny this, claiming that there are easily enough clients who do not want banking services combined with their clearing service. While others admit that deep banking relationships can be leveraged into clearing business foundations, they claim that most banks do not provide

the same quality of service as the clearing firms which have built expertise in the markets.

The traditional Chicago clearers point out that the banks themselves need to recognise the trend towards a full service operation. "It is not that the investment banks and brokerage firms are not conscious of this trend because they saw that before the banks. The investment banks like Morgan Stanley and Salomon have that capability," indicates Melamed.

The development of value-added services parallels the fierceness of the competition. Cross-collateral operations for clients have expanded as new markets have opened up, and more sophisticated services are a bid to attract new entrants to the market. Chicago brokers point out that they are restricted in the way they are permitted to extend credit to US customers, whereas overseas brokers are free to offer such services to the same clients.

### **Consolidation continues as the commission dollar is worn down to the bone**

Clearers are striving towards easier access for clients to account records and position statements, at the same time as customers become increasingly familiar with the products traded on their behalf.

Quantum's central service aim is to provide full computerised downloading from their mainframe system. The firm believes it has a boutique approach to its customer base — they do not get lost in a large system, says Rosenthal. He adds that the ability to take in business for central clearing from give-up sources is also crucial.

Quantum says it will also service clients from the other end, structuring give-outs for CTAs who do not want to make an arrangement with a central clearer. The firm breaks up a large transaction for a CTA and hands portions out to various other clearing firms. The added value lies in giving a client a centralised location for its business and then arranging who will handle the clearing.

Other firms are investing heavily in cutting-edge systems as information flows become ever more important, and in order to streamline the clearing process. Rand aims to be "on the economically-rational leading edge of technology," and is currently working on an electronic order-entry system as well as the possibility of offering real-time, on-line customer statements through-

out the day. "We need to be on the leading edge in providing what the customer wants from a clearer. It is crucial that we find out what they will need from us, so we have to visit them as much as possible — we travel extensively," explains Quinto.

As potential customers are bombarded with increasingly sophisticated complementary services, many have stressed the need for efficient customer back-up services. When a problem occurs, the client will demand to know where it lies and how it will be remedied. Quantum has developed a 24-hour customer services department manned by personnel who understand the whole transaction process from execution to final settlement and clearing. "If there is a key-punch error, then our staff will recognise that and know how to deal with it quickly," claims Rosenthal. "In this business, systems and software are our first line of defence, but people are the most important element. If you don't have transactions followed by our staff, who knows where the whole process will fall down from a systems angle?"

Another reaction to competition is to reduce costs, the result of which has been that several clearers have merged the settlement operations of different market sectors, combining processing of securities trades with futures and options, for example. Having a centralised department also facilitates more efficient customer servicing and troubleshooting of cross-border transactions. "Achieving centralised settlement depends on getting the right systems, but I now believe there is no way you can be in this market without that," says Melamed.

To survive in Chicago, and implicitly in the global clearing market, many players believe the key is providing a quality service across markets. They say that participants will need to comprehend the synergy between the various components of a full service risk management capability and how these components interact with each other.

Customers are ever eager to obtain cost efficiencies by placing their cross-border, cross-market business in the hands of one clearer. The highly experienced Chicago-based clearing firms, while hoping to retain their boutique style operations, have realised this and are expanding their services either internally, or by negotiating favourable relationships with other clearers.

The large bank FCMs have a natural advantage in offering diverse additional services, but will need to challenge the established expertise of the smaller boutiques. As the market expands, the indications are that if players offer a full risk management service, there will be room for both types of operation in the clearing market of the future. □