Financial Technology Intelligence

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EXCHANGES

Back to the Futures

An upstart alternative US futures exchange seeks to put competitive pressure on the Goliath Chicago Mercantile Exchange. Does this David have a shot?

By Emily Fraser

A start-up futures exchange is confidently entering the ring to take on the Goliath CME Group, but few industry observers so far are betting on the underdog. A consortium of global banks, hedge funds and a technology vendor is building a new low-cost US futures exchange to rival the CME, which could soon control 98 percent of US futures contracts if its bid to buy the New York Mercantile Exchange (Nymex) goes through.

Bank of America, Barclays Capital, Citi, Credit Suisse, Deutsche Bank Securities, JPMorgan, Merrill Lynch, and Royal Bank of Scotland have joined forces with Chicago-based trading firms Getco and Peak6, and heavyweight hedge fund Citadel to launch a new all-electronic exchange, powered by eSpeed technology, during the first half of 2008. The new exchange will be called ELX Electronic Liquidity Exchange. A management team was yet to be named at press time.

The consortium has been very tight-lipped about its strategies and goals, although a source at one of the member firms who is familiar with the situation spoke to *Waters*, on condition of anonymity. "There is a real need in the market for a viable commercial alternative to the CME," says the source, especially in light of the recent consolidation in the market.

The CME takes the effort very seriously, says Leo Melamed, the exchange's chairman emeritus, and chairman and CEO of Melamed and Associates. Melamed was chairman of the CME from 1969 to 1978 and is often hailed as the founder of the financial futures markets. "They do represent some very competent and important names in our industry and so clearly one has to attempt to understand why they are doing what they are doing and to take the correct measures so that the CME does not get hurt in the process," he says. "This is not the first effort by many of these players to do this kind of thing, and in the past they have not met great success. But that doesn't mean they shouldn't try again and they might have learned something that would be different this time. We hope not," he adds.

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>
> *Source at a consortium member firm*

Cantor Exchange, BrokerTec and Eurex US launched new futures exchanges to take on the CME in 1998, 2001 and 2004, respectively. None of these ventures survived on its own in the long term, and nay-sayers expect this attempt to be no different. These previous entrants brought about some short-term relief on pricing, however, thanks to the extra competition in the market, says Brad Bailey, formerly senior analyst with Aite Group who recently moved to Knight Capital.

LIQUIDITY CHALLENGE

Gaining liquidity will be the new consortium's biggest challenge. "It's very hard to compete for established order flow," says Craig Pirrong, professor of finance and director of the Global Energy

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Management Institute at the Bauer College of Business at the University of Houston. "The CME already has a dominant position in Eurodollars and Treasuries, and liquidity attracts liquidity. It's very difficult to wrest that away," he says. "Maybe the fourth time is the charm, but I don't think so," he says. Melamed echoes his point. "All the participants in the market want to utilize the safest and most established avenues of trading. The huge liquidity is a most attractive reason to stay with the CME," he says.

The source involved with the consortium acknowledges that gaining liquidity will be a challenge and the new entrant will need to offer a compelling alternative to the CME with a lower cost to trade. "We're going to have to pull together the consortium and really make sure that everybody is pulling their desks together and putting liquidity out there. It's just something we're going to have to all work together at," the source says. "The CME is a very large organization with a lot of legacy infrastructure that it needs to support. Our hope is that we as a smaller, leaner organization can run at a far cheaper rate and that rate will be reflected in lower cost per execution," the source adds.

Despite receiving the green light from the US Department of Justice's (DoJ's) anti-trust auditors, the CME currently operates a quasi-monopoly in the US futures market. Since its acquisition of the Chicago Board of Trade (CBOT) last year, almost 87 percent of US futures are traded there, according to the Futures Industry Association (FIA). The CME also recently announced plans to purchase the Nymex, which currently accounts for 11 percent of the futures market. This deal has been in the pipeline for the past 10 years and the timing of the announcement has nothing to do with the consortium's plans, say CME officials. Pirrong says there is less competitive overlap between the CME and Nymex than there was with the CME-CBOT merger, and he expects the deal to pass the anti-trust audits.

The CME-Nymex deal has recently hit turbulent waters, however, as the DoJ released a letter recommending that clearing be separated from exchanges in the futures markets. Clearing is a significant source of revenue for both CME and Nymex, and the news caused shares in both exchanges to plummet, prompting CME to improve its offer to reflect the lower share value, according to reports.

The consortium sees its efforts as the beginning of the next phase of the futures markets. "Hopefully, we can get it to look a lot like the equities market domestically, where there is a lot of competition, settlement is centralized and not vertically integrated with the participants, products are fungible and costs are low," the source says.

This venture will be different from the failed attempts of the past because the participants this time have an equity stake in the exchange's success, the source says. The value proposition for the previous attempts was around trading cost reduction, which made it easy for the CME and CBOT to undermine by lowering fees temporarily. "You can get the right people in the room, you can give them an electronic platform, you can sell them the value of what's going on, but once you add in the equity angle, once participants are actually motivated by having a stake in the success of the venture, that's a very powerful argument," the source says.

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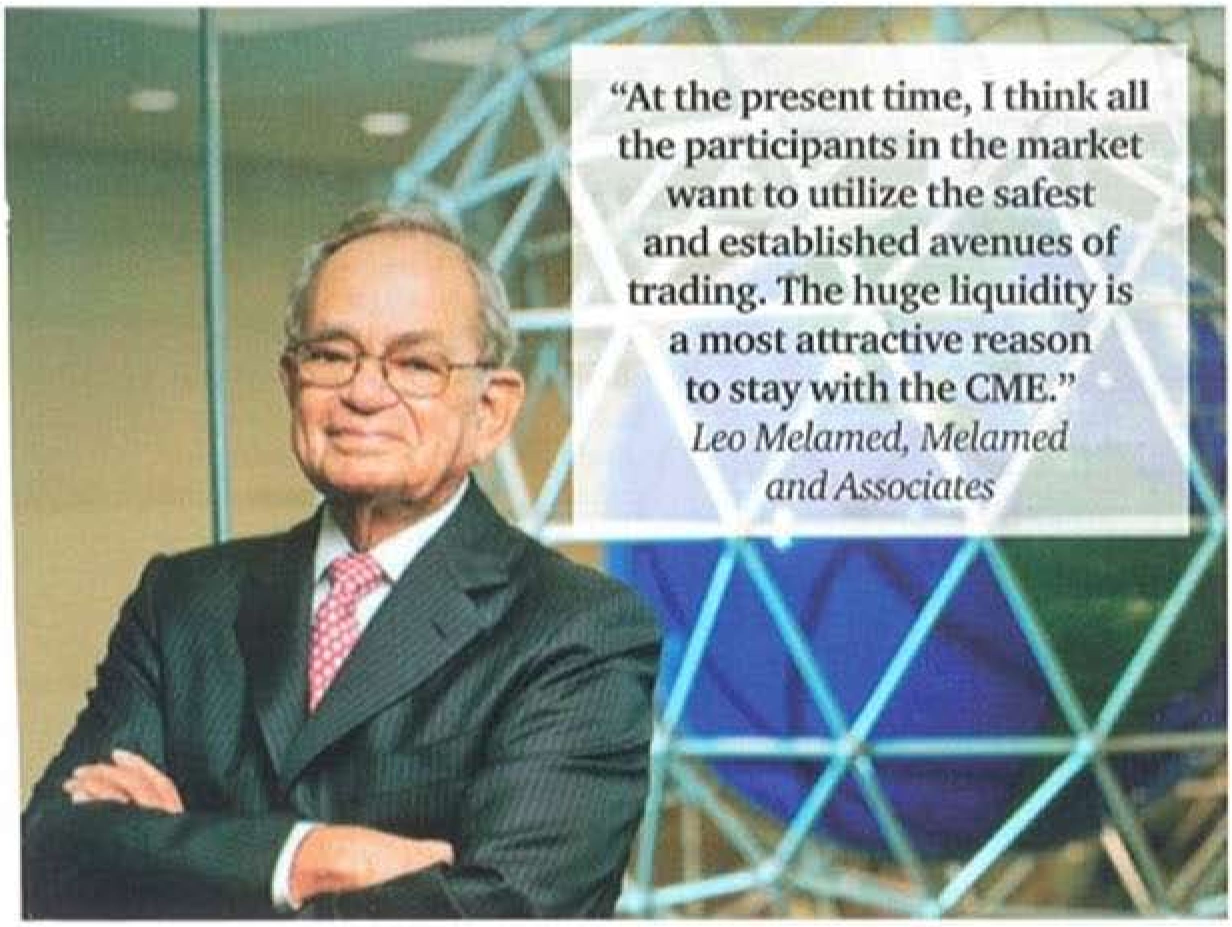
Viraf Reporter, Tabb Group



"At the present time, I think all the participants in the market want to utilize the safest and established avenues of trading. The huge liquidity is a most attractive reason to stay with the CME."
Leo Melamed, Melamed and Associates

PRICING WAR

The new exchange aims to differentiate itself from the CME in terms of fees and technology, but in this sort of situation, an incumbent can respond to the price competition until it goes away, says Pirrong. "It's a question of 'I'll see you and raise you—or rather, see you and lower you'" he says. Pirrong expects to see a price war for a couple of months that will certainly dent CME earnings, but he says, "At the end of the day, the competitor will go away and CME will just jack up its prices back to where they were."

The consortium members, meanwhile, are confident that an extended pricing war will be beneficial for the marketplace—of which its members are active participants—and that the group has enough financial backing to withstand such a battle for a very respectable

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amount of time, the inside source says.

Viraf Reporter, senior consultant at research firm Tabb Group, suggests that the consortium might not actually be interested in succeeding in the traditional sense. Gaining market share is likely not the members' goal because being an exchange is not their core business, he says. "The consortium is trying to do something about the cost of continuing to trade. If the CME lowers their fees, I think they've won," he says. However, if the previous ventures are any indication, any pricing relief gained could be temporary and measured in months, Pirrong predicts. The consortium insider says the new exchange fully intends to be an active part of the marketplace five years from now and beyond.

Melamed, who is also chairman of the CME's strategic board steering committee, says that plans to reduce execution fees at the CME are "part of a long-range strategy."

Pirrong says he believes the consortium has serious intentions of launching an exchange, but that it could face more difficulties than anticipated. The fact that the group consists of several natural competitors could make it difficult for

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them to work together efficiently, and furthermore, the consortium is made up of very diverse firms, which naturally look at things from very different perspectives, he says.

In terms of technology, the new exchange believes its eSpeed platform will be on par with CME's Globex, but the incumbent plans to give it a run for its money. The CME is rolling out an upgrade to its Globex trading platform this month, reducing roundtrip times from 30 milliseconds to 15 milliseconds, according to exchange officials.

The third largest futures exchange—the IntercontinentalExchange (ICE), which is very strong in energy futures but accounts for a little under 2 percent of the total futures market—has also undergone a complete overhaul of its technology infrastructure, which the exchange says now delivers average transaction times of 3 milliseconds in ICE futures. The ICE would have a greater share of the total market compared with the CME, if it had been successful in its last-minute bid for the CBOT last year.

With these recent upgrades the new exchange will need to show it offers an advantage because its technology is more advanced. "It's not like an electronic competitor going against an open outcry exchange, like Liffe versus Eurex in 1998," says Pirrong.

Nonetheless, it is much easier than it once was to set up an electronic exchange, says Bailey. "Look at Bats Trading," he says. "With ultra-competitive rates, you can build connectivity quickly and high-volume traders are always looking for a cheaper trade."

As with options, there is no legal framework in the futures marketplace for alternative trading systems (ATSes) or ECNs. The consortium will have to obtain exchange status in order for trading to commence, a process which can be drawn out. Pirrong says he is doubtful that a launch in the second quarter of this year is feasible—although he says it will be much quicker than the five years it took the Nasdaq Stock Market to gain its exchange status. ■

US Futures Trading Volumes

Exchange	January to October 2007
CME Group	2,344,222,292
New York Mercantile Exchange	295,961,277
ICE Futures U.S.	45,703,228
OneChicago	7,355,399
Kansas City Board of Trade	4,032,448
Minneapolis Grain Exchange	1,516,524
CBOE Futures Exchange	854,244
Chicago Climate Exchange	219,295
US Futures Exchange	1,591
Total US Futures Exchange Volume	**2,699,866,298**
of which CME:	**86.83%**

Source: Futures Industry Association