New Perspectives on the FCM Business

By Will Acworth and Joanne Morrison

As policymakers craft new rules mandating clearing for most over-the-counter derivatives, three new futures commission merchants have entered the clearing business.

Both State Street and BNY Mellon are offering clearing services designed to dovetail with the OTC derivatives processing and collateral management services that they offer to institutional customers. Both banks are also looking to offer direct access to futures exchanges in the U.S. and abroad.

For Wells Fargo, the decision to form an FCM grew out of its recognition that its institutional clients would need access to clearing services for their interest rate hedges. The bank has joined CME Clearing and plans to clear interest rate swaps at other clearinghouses as well.

BNY Mellon Leverages Custodial Services

BNY Mellon's decision to establish an FCM was a logical extension of the bank's business model, explained Sanjay Kannambadi, the executive who developed the strategy and is now putting it into effect as the bank's global head of clearing. Kannambadi explained that the bank is a leading custodian and securities services provider for institutional clients around the world. Many of these clients trade derivatives and will need a clearing partner as the regulatory reforms are implemented.

"We decided to go down this path in response to demand from our clients, regulatory changes underway and the derivatives market's transition to clearing," said Kannambadi. "We had many inquiries from clients globally and largely based on their input we decided it was time for us to move into this marketplace to serve their needs."

While there are many other large banks that have been operating FCMs successfully for some time, Kannambadi believes that BNY Mellon can leverage its position as a custodian to offer clients a superior service in collateral management. He noted that BNY Mellon is the largest custodian in the world with $25 trillion in client assets, and as part of this service it helps mobilize these assets for derivatives and other transactions. For example, clients can leverage BNY Mellon's securities lending capabilities to meet the clearinghouse requirements.

"There is a huge synergy in collateral management that we can bring to the table as an independent custodian and FCM," said Kannambadi. "With the proper authority from our clients, the margin monies can be moved from the custody account into the segregated customer account at the FCM very efficiently."

BNY Mellon Clearing LLC, the formal name for the FCM, registered with the National Futures Association last year and went live in June 2010. As an initial step, the FCM set up a relationship with MF Global as a "facilities manager" for listed futures, under which BNY Mellon can access more than 50 exchanges worldwide through the infrastructure and connectivity provided by MF Global. MF Global also functions as the firm's carrying broker for positions at certain clearinghouses. Kannambadi stressed that all of the front office functions and clearing operations, including margins and risk, are carried out by BNY Mellon.

In terms of building direct connectivity, he said BNY Mellon Clearing will evaluate potential memberships based on "where our clients want to clear" and added that the bank has clients in more than 100 countries. The FCM is a clearing member of CME Group, giving it the ability to clear listed derivatives traded on all of the group's exchanges. The next step is to build direct access to exchanges and clearinghouses outside the U.S. "We are setting up an affiliated FCM in Dublin and once we obtain regulatory approval from the Central Bank of Ireland we will seek membership in European and Asian exchanges," Kannambadi said. The Dublin FCM is headed by Tim Murphy and recently named Charlie McGreevy, the former European Commissioner for Internal Market and Services, as a board member.

A mechanical engineer by training, Kannambadi has been at BNY Mellon since 2001 and has led a number of strategic initiatives across finance, operations and technology. Before being named head of the FCM, he headed the bank's office of innovation.

As part of the build-out of the FCM, the bank has hired several executives with extensive experience in derivatives. Alasdair McBarnet, a former co-head of the global futures and options business at Bear Stearns, joined BNY Mellon Clearing in May as chief operating officer. Louis Potestio, an expert in futures operations with experience at Deutsche Bank Securities, UBS and HSBC Securities, joined the company in March. David Buchalter, a derivatives lawyer who spent many years working at Prudential Financial, was hired as managing counsel in legal affairs.

While the existing FCM business is highly competitive, Kannambadi said the transition to central clearing for OTC derivatives has opened the door for firms like his. "Yes, the listed futures business is crowded, but cleared swaps is a new market," he commented. "The infrastructure is different and everyone is starting from scratch." He added that BNY Mellon has a large derivatives desk and a large swaps book in the bank. "We are fairly active in OTC rates, structured products, swaptions and other products. That is a long-standing competency of the bank."

BNY Mellon Clearing is a member of International Derivatives Clearing Group and is applying to other clearinghouses for interest rate swap clearing. The FCM is also a member of Eris, a trading venue established last year that offers futures designed to replicate interest rate swaps.

"We are agnostic on clearing. We will clear books of business on most any venue. Clients can execute with their brokers and give up to us."

"Yes, the listed futures business is crowded, but cleared swaps is a new market."
—***Sanjay Kannambadi***, *BNY Mellon*

State Street Capitalizes on Dodd-Frank

Rather than competing with the prime brokers on execution services, State Street is looking to offer a combination of services that builds on its position as one of the top custodial banks. The bank also is building up its ability to offer execution and clearing services for listed derivatives in Europe and Asia.

State Street's FCM, which is registered with the Commodity Futures Trading Commission as State Street Global Markets LLC, has been operating since 2009. In the listed derivatives business, State Street is a clearing member of CME, Eurex and NYSE Liffe and has access to 46 exchanges worldwide. On the OTC side, State Street is a member of IDCG and intends to be a member of all of the major OTC clearinghouses for interest rates, credit and foreign exchange.

Steven Winter, global head of futures and OTC clearing, says the FCM has a unique advantage because of State Street's custody business. With roughly $25 trillion in client assets in custody, State Street has a relationship with some of the world's largest financial institutions.

"Our clients are looking for a different model. When you look at the FCMs in the world today, it's been pretty constant," said Winter, who joined State Street in November 2009. "There hasn't been a lot of new entrants in the marketplace that deal with institutional clients," he said. "Our advantage is that we have all the best quality clients because we deal with them in custody."

As a custody bank, State Street is one of the largest agency processers of derivatives transactions. Winter says that because of this, there are a lot of efficiencies built into the FCM. "Today we provide a full range of clearing and execution and collateral management. When tied to State Street's other offerings, it makes it truly seamless."

Before joining State Street, Winter was a managing director at Banc of America Securities and before that he was North American head of futures and fixed income prime brokerage at Barclays Capital. Winter brought on board Ray Tubridy, formerly global futures operations manager at Merrill Lynch, who was named managing director of marketing and product development in January 2010. More recently, Steve Martin was hired from SEB Futures in London to be the head of futures for Europe and Asia-Pacific. In addition, Gemma Lloyd, also formerly of SEB, was hired as vice president, clearing sales and business development in London.

"While we are a relatively new FCM, we have the experience and knowledge of well-established longer-term FCMs without all of the legacy issues," Winter said.

Winter applauded the regulatory reforms being developed as a result of the Dodd-Frank Act, which he predicts will help drive OTC business to the FCM model. "I think it's good for the industry and I think it's good for the clients," he said, adding that the biggest challenge is getting all the constituents properly educated. "These reforms are designed to take out systemic risk and add transparency and there is the potential to add liquidity."

Winter predicts that the clearing and trading requirements in Dodd-Frank could ultimately reduce costs and allow for "many more trading opportunities, particularly when you bring the swaps part more into a model like the futures model," he said.

But he warned that new rulemaking must be addressed on a global basis. "The markets affected are global in nature, both from a user and product perspective and, as such, it is imperative that there is harmonization of the regulations to prevent regulatory arbitrage."

Winter predicts ultimately that global regulations will be largely in tune with reforms in the U.S. "Realistically, no legal jurisdictions wants to become the haven for moral hazard."

Wells Fargo Adds Client Clearing to Swaps Dealer Business

Wells Fargo is another relatively new entrant into the derivatives clearing business. The bank last fall began creating the necessary infrastructure within its FCM, hiring key people and revamping its derivatives processing systems for clearing. The FCM is registered with the CFTC as Wells Fargo Securities LLC and most of its staff works out of Charlotte, N.C., which is the main center of operations for the broker-dealer side of the parent organization. Jeff Gore, a managing director with years of experience in deriva-

"Our advantage is that we have all the best quality clients because we deal with them in custody."
—***Steven Winter***, *State Street*

"Our derivatives processing operations were built for the bilateral OTC business. We are now re-purposing those operations to support centralized clearing for our clients."
—***Jeff Gore***, *Wells Fargo*

tives operations, was put in charge of derivatives clearing services last November and is now building out the FCM.

This year WFS is focused on clearing interest rate swaps, which account for a large share of the bank's overall derivatives portfolio. In January WFS was approved as a clearing member by CME for interest rate swaps clearing and it expects to become a member of other clearinghouses soon. WFS also plans to evaluate the possibility of offering clearing for other products once the first group of products is on board.

In contrast to most other banks in the derivatives business, Wells Fargo is more focused on middle market institutional customers (between $5 million and $200 million in annual revenues) than they are on larger Wall Street firms. The bank is one of the largest commercial lenders in the U.S. and has strong relationships with corporate customers across multiple industries all over the country.

Much of Wells Fargo's derivatives business today is conducted with non-financial end users, primarily linked to the commercial lending and capital markets services that the bank provides to these customers. The bank's customer base also includes financial end users that will be subject to the Dodd-Frank clearing mandate. For example, Wells Fargo might enter into an interest rate swap with a regional bank to help it manage its interest rate risk. Under Dodd-Frank, some portion of that business may have to be cleared.

The bank also enters into a large number of interest rate derivatives to hedge its own risks. As one of the largest players in the U.S. mortgage market—the bank estimates that it services one out of every six mortgages in America—Wells Fargo is exposed to many different kinds of interest rate risk and has developed a sophisticated hedging operation that uses mortgage forwards, interest rate swaps, futures and options. Now that Wells Fargo has its own FCM up and running, it has the ability to self-clear those products if necessary.

"Last fall we decided to set up our own clearing operation to support our house derivative activity as well as our customer derivatives," said Dan Thomas, head of rates sales and marketing. "We are focused currently on offering clearing services for interest rate swaps to our customers, especially those that have a need to clear in order to comply with Dodd-Frank regulations. We expect to add other asset classes in the future."

As of December 2010, Wells Fargo had $3.4 trillion notional in OTC derivatives, according to the Office of the Comptroller of the Currency, a branch of the U.S. Treasury Department that oversees national banks. That is enough for the bank to rank among the top five in the U.S. banking industry in terms of derivatives exposure. Wells Fargo is also a member of the Group of 14 swap dealers that has made commitments to the Federal Reserve Bank of New York and other regulators for the last several years in an effort to improve the derivatives markets, enhance transparency and reduce risk.

As a result of Wells Fargo having a large customer-focused swaps business, WFS starts out with a fairly sophisticated back office system to support the processing of OTC derivatives transactions. The derivatives operations and technology groups number more than 300 people, and together they are working to enhance the trade workflow to support central clearing. Gore explained that Wells Fargo's derivatives IT system is built around technology provided by Calypso, one of the leading software vendors for OTC derivatives. The system collects information on both cleared and bilateral trades in one location so that WFS can provide centralized reporting on collateral, reconciliation, open positions and margin estimation.

"Our derivatives processing operations were built for the bilateral OTC business," commented Gore. "We are now re-purposing those operations to support centralized clearing for our clients. We think this experience positions us very well to understand the IT challenges of clearing products that are significantly more complex than listed futures and options."

Case in point: LCH.Clearnet is expected to begin clearing amortizing swaps by the end of 2011. Gore explained that clearing this product will be more challenging than clearing futures because the size of the swap decreases over time, much like a mortgage. FCM clearing systems therefore need to have the ability to adjust the notional size of the swap in line with the amortizing schedule.

Wells Fargo also anticipates that swaps trading will migrate to swap execution facilities, a new type of trading venue created by Dodd-Frank. To develop its strategy in this area, the bank is tapping expertise across different divisions of the bank. For example, the rates trading division includes people with experience trading not only interest rate swaps but also cash Treasuries and interest rate futures, giving it insights into several different models for how market structure may change. Another important contribution to its strategy is coming from the bank's equities division, which lived through an explosion of electronic trading venues during the previous decade. That might be a model for what happens to the swaps market once the rules that create swap execution facilities take effect, according to C. Thomas Richardson, managing director with responsibility for market structure and strategy at WFS.

Richardson, an equities market veteran who played a key role in steering Citigroup's equity division through the regulatory and technology changes that transformed the U.S. equity markets during that period, said he expects that most market participants will initially focus on clearing but SEF execution may start gaining traction in the latter half of 2012. Given that there are likely to be multiple SEFs competing in each asset class, he anticipates that liquidity may be fragmented among multiple venues. While the SEF rules are not yet final, several dealer-to-client platforms such as Tradeweb and MarketAxess and a number of inter-dealer brokers such as BGC, GFI and ICAP have said they plan to seek recognition as SEFs.

"As SEFs build liquidity and gain more traction, the need for aggregation technology will become paramount as the marketplace becomes increasingly fragmented," Richardson said. "This is why we are currently working on aggregation technology that will be designed to aggregate SEF market data in real time which we will then stream out through our portal to our FCM client base. In terms of who we will connect to, Wells Fargo will put forward a thoughtful approach and connect to a mix of client-facing SEFs and IDB SEFs."

Will Acworth and **Joanne Morrison** are editor and deputy editor, respectively, of *Futures Industry*.

A Crowded Field

BNY Mellon, State Street and Wells Fargo face tough competition as they build up their futures commission merchant subsidiaries. The table below shows the top 30 FCMs based on customer segregated funds as of March 2011.

Rank	Company Name	Mar-10	Mar-11	% Change
1	Newedge USA LLC	$18,532,190,605	$23,498,617,555	26.8%
2	Goldman, Sachs & Co.	17,848,704,724	21,764,949,000	21.9%
3	J.P. Morgan Futures Inc.	13,865,198,686	16,821,242,735	21.3%
4	Deutsche Bank Securities Inc.	13,022,205,803	16,365,066,676	25.7%
5	Citigroup Global Markets Inc.	9,887,372,326	10,066,221,125	1.8%
6	UBS Securities LLC	9,690,365,107	9,967,622,476	2.9%
7	Merrill Lynch Pierce Fenner & Smith	8,747,382,785	9,581,310,967	9.5%
8	MF Global Inc.	7,381,701,924	8,077,773,388	9.4%
9	Credit Suisse Securities (USA) LLC	4,333,246,998	5,614,260,540	29.6%
10	Barclays Capital Inc.	4,288,557,999	5,512,110,026	28.5%
11	Morgan Stanley & Co. Inc.	5,197,288,134	4,695,017,336	-9.7%
12	Prudential Bache Commodities LLC	2,611,285,000	3,168,872,000	21.4%
13	ADM Investor Services Inc.	2,102,776,521	2,486,938,778	18.3%
14	R.J. O'Brien Associates LLC	1,759,369,720	2,473,650,360	40.6%
15	RBS Securities Inc.	1,333,069,000	1,991,801,000	49.4%
16	ABN Amro Clearing Chicago LLC *	1,112,201,533	1,786,382,780	60.6%
17	Rosenthal Collins Group LLC	1,204,398,992	1,608,379,814	33.5%
18	BNP Paribas Commodity Futures Inc.	1,380,129,215	1,531,762,736	11.0%
19	Goldman Sachs Execution & Clearing LP	1,280,314,220	1,262,050,109	-1.4%
20	FCStone LLC	1,034,532,571	1,227,964,576	18.7%
21	HSBC Securities USA Inc.	685,871,518	974,564,160	42.1%
22	Merrill Lynch Professional Clearing Corp.	1,097,279,946	941,107,835	-14.2%
23	Mizuho Securities USA Inc.	687,951,590	840,667,647	22.2%
24	McVean Trading & Investments LLC	577,944,506	831,065,826	43.8%
25	Penson Futures	491,358,725	788,900,533	60.6%
26	Macquarie Futures USA Inc.	661,910,995	735,384,573	11.1%
27	Interactive Brokers LLC	497,322,114	728,922,719	46.6%
28	Morgan Stanley Smith Barney LLC	0	623,604,905	NA
29	BNP Paribas Securities Corp.	357,871,022	612,171,378	71.1%
30	Timber Hill LLC	457,828,900	549,868,907	20.1%
	Total Customer Funds Held by All FCMs	**$136,693,593,403**	**$163,052,680,828**	**19.3%**

Note: Ranking is based on the total amount of funds that futures commission merchants are required to segregate on behalf of customers trading on a U.S. futures market. FCMs owned by the same holding company have not been consolidated.

* Successor to Fortis Clearing Americas LLC

Source: Commodity Futures Trading Commission