2016 was a challenging year for futures brokers, but one that offered relief with the first interest rate increase in more than a decade and further signs of optimism.

top 30 brokers of 2016

That odd sound is optimism

by Daniel P. Collins

It was another year of transition for future commission merchants (FCMs) as the new regulatory structure took hold and constant pressures on capital had futures brokers minding the bottom line to navigate the narrow path to profitability. The evolution of regulations forced FCMs back into traditional lanes as mid-level joint brokers were forced out of the foreign exchange market. "We were transitioning out of FX business and are now doing well even in this environment," says John Bartleman, president of TradeStation Securities.

The political shocks in Europe and America provided volatility to exploit. "The markets that have stood out are the [ones that were affected by] the Brexit vote and the U.S. election," says Chairman and CEO of R.J. O'Brien &Associates Gerry Corcoran.

"We're witnessing significant changes in the political climate in many countries around the world, and these types of changes often drive volatility," says Scott Gordon, chairman & CEO, Rosenthal Collins Group. "We experienced this with Brexit and the U.S. presidential election, and our markets handled it quite well."

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This spurred U.S. equity and fixed income markets. Tom Kadlec, head of ADM Investor Services, says, "The fixed income sector has done well. There has been a steeper yield curve and that has [helped the] interest rate complex." He added that the grains and metals sectors also did well.

When Corcoran discusses volume, it is not necessarily overall volume but what he describes as profitable volumes. "Overall our volumes are higher, but we like higher volume in higher gross profits products," Corcoran says. "Historically, we haven't participated in the 'algo' high volume trading business because we have directed our resources to less intensive and higher margin business. The capital investments to participate in the algorithmic arena are substantial. We like products in which we can develop a lasting relationship with clients that have a great risk-adjusted rate-of-return."

That is a sign of how the industry has changed in recent years. Gone are the days of simply going after scale for scale sake. Profit margins are narrow, and while Corcoran adds that creating scale in your areas of expertise is extremely important, the FCMs that have survived eight years of zero-interest-rate policy have had to be smart and selective to stay in business.

"The greatest challenge is continuously improving in all areas of process and operational efficiencies," Kadlec says. "If you have those down, then the regulatory challenges, the accounting challenges, the treasury challenges, the risk challenges, all are mitigated. We work real hard on our internal processes."

COST OF BUSINESS

The ranks of FCMs have continuously shrunk during the last decade as the cost of business continues to increase (see "An exclusive club," below). FCMs blame this on price competition, the rising cost of compliance and technology, lack of competition in the exchange space and a low interest rate environment.

"A challenge for FCMs [in 2017] is going to be the continued rising cost of just doing business; and compliance is a major factor in that," says Bartleman.

"The biggest challenges for FCMs since the 2008 financial crisis have been the double whammy of significantly increased and more costly regulations, and low interest rates," Gordon says. "The regulatory burden has risen every year. In the [United States] it looks like we may be starting to come to the end of this cycle. A moderation in new regulations will be an improvement."

International institutional brokers have their own issues. "The cost of running the primer broker has grown; the cost of regulations, the cost of capital, the cost of technology have really grown," says Alain Courbebaisse, head of prime clearing service for SG Americas. "To differentiate yourself means to be a firm that permanently invests [in] more services, more secure services, faster services, more asset classes, more cross margining and cross border [business]. The cost of running this business has really grown. It is difficult to find profitability."

This has been true particularly with large bank FCMs, which have unique issues. "Today, the customer cash that is used to cover customer Initial margin at clearinghouses is hitting our balance sheet 100%, Courbebaisse says. "Some relief from this rule would be beneficial to our and other [bank FCM] balance sheets and therefore their profitability."

It is a situation that has opened opportunities to non-bank FCMs. "we have seen the benefits in 2016 of expanding our global footprint and expanding further into the middle market institutional business. It is working out very well for us," Corcoran says. "This is a marketplace in which the banks are being very selective about who they serve, and therefor there are customers and salespeople who are coming to the middle market FCMs. We are well-suited to service those customers and provide a great opportunity for salespeople."

Lack of competition in the exchange space also is a common complaint. "The exchange's fee structure is difficult to work with; it handicaps firms like ours in how we price to our customers," Bartleman says. "We are a retail shop and we work closely with CME, but they haven't been able to get past the fee structure. Tick instrument pricing are obstacles to our retail traders."

Bartleman explains that commodity based ETFs are much easier vehicles for a retail trader to get into and are competing successfully with futures because of their structure. "They are not better, but they are easier to understand," he says. "CME is attempting to work with customers like ours, but it will require changes to its core fee structure."

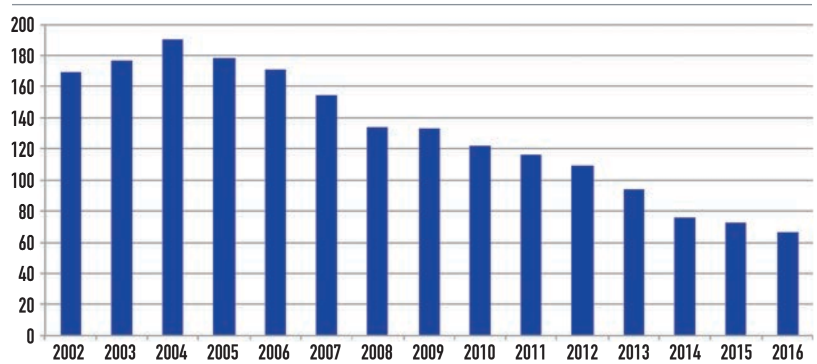
He points out that with equities his firm can offer clients a flat price ticket depending on the volume, but with futures they can't do that. "Everyone has to pass through commissions plus fees. The data fees are huge as well," Bartleman adds.

This affects all FCMs. "The exchanges are very well-positioned for what they do and they have pricing power," Corcoran says. "In most cases when the exchanges raise costs, we pass that on to customers, but ultimately it is a cost to the industry that has to be consumed; in the long run more competition would be better."

Kadlec agrees. "I have many competitors and many different levels of competitors; my biggest hurdle is dealing efficiently with both the CME Group and ICE who make unilateral decisions that have dramatic effects on all 60 FCMs," he says. "That includes monolithic cost increases for things like data services; when you price business at high levels, the only non-negotiable cost from an FCM standpoint is clearing fees at an exchange."

AN EXCLUSIVE CLUB

The ranks of FCMs continue to shrink; if at a slower pace.



Source: CFTC

NO GOING BACK

While everyone likes to complain about regulations, no one seems to want to go back, and most feel that the tough regulatory environment has allowed the brokers with the best processes to survive.

"I am not in favor of the repeal [of Dodd-Frank]; that [would create] too much uncertainty," Kadlec says. "Banks got way out over their skis, and capital discipline is a good thing. There should be a rational and pragmatic approach to regulation." He would like to see some adjustments while maintaining strong capital requirements.

Corcoran adds, "I don't see the regulations in the futures business being rolled back. We have become accustomed to working with what we have today."

Nor would he want to, though he says it is a hopeful sign that President-Elect Donald Trump wants to eliminate two regulations for every one created.

"There was a ton of great regulations put in place subsequent to MF Global and PFG that has ensured lasting protection for customer assets and I would not want to see those rules rolled back," Corcoran says.

Kadlec says regulations need to be rational. "They need to help FCMs with challenges. If you go back to one of the things I disagreed with — which was the residual interest calculation — once we recognized that it was

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—John Bartleman

going to be implemented, we adjusted our business model," he says. "We adjusted to requiring customers to meet margin calls quicker; with hindsight that is a good thing for us. It decreased our counterparty risk."

FCMs often complain that there is a constant rise in costs with no opportunity to increase revenue, but this rule was different. "We created a fee that incentivized customers to meet their margin calls quicker," Kadlec says. "We decreased out counterparty risk and increased our fee-based income. Those two things are good."

He says the commission had a good idea. "Not all rules are like that," he adds.

For most FCMs we spoke to it is not necessarily the amount of regulations, but the manner recent regulations have been implemented and enforced since the credit crisis. "From our firm's perspective there isn't a specific rule that we want changed, it is just the holistic approach," says Bartleman, who says the CFTC has been reactionary and would prefer them to work with the brokerage community. "Regulators [should] stop this reactionary approach, regulating through enforcement, and move more to a risk-based approach in working with the broker dealers and understanding their make-up. You are always waiting to get dinged on something that is arbitrary. A lot of [rules are] not customer focused."

Corcoran has seen this as well. "There is no doubt that the intensity level of enforcement by regulators has been much higher in the last five years than it was in the 25 years prior," he says. "It is hard to say whether that has been good or bad. Every enforcement action has its own characteristics, but what has been lifting the industry's eyebrows are the high levels of fines for rule breaches that didn't historically warrant those fines."

But arguably the highest cost increase was not one mandated by regulators but by fear of data breaches.

CYBER SECURITY

"Cyber risk is huge and omnipresent," Corcoran says. "Every year we invest more and more resources to protect our business and our customers' identities and confidential information. There is cyber-crime attempted every day in this industry, and RJO is not immune to that."

Everyone agrees cyber security is a huge issue. "It is one of the biggest concerns of any financial institution. We are very actively monitoring and trying to get better [oversight]," Courbebaisse says. "It is especially an area of concern for us and other primer brokers."

"It is one of the items that keep me up at night," Bartleman says. "We invest heavily to make sure our systems are secure. For us it is an ongoing cost of doing business. It doesn't add to revenue at all, but reputation. Just making sure your client's information is secure, it is not just FCMs, it is across the board, it is something we all have to live with."

It is something that must be addressed industry wide. "It has been increasingly apparent that cyber security is a shared burden with the need for exchanges, FCMs and regulators to work in concert to protect data and the integrity and liquidity of markets," Gordon says. "It's also dynamic. A company can't just put a set of protections in place and say they're done. We have to be constantly vigilant against the next threat as there's always a new one."

That is the tough part. "The guys who participate in cyber crimes keep getting better and better so there is no status quo on how you protect customers and confidential information," Corcoran agrees. "You think you have everything protected and then your IT cyber-security experts say there is a new risk. It is huge."

Kadlec says the cyber rules the NFA and the [CFTC] have embraced is a good thing. "They have taken a rational approach to the cyber rules knowing that the full documentation doesn't happen overnight."

RATE RELIEF

With all the headwinds during the last decade the largest challenge may be the lack interest income. Even the quarter-point increase in the Fed Funds rate in December 2015 had a positive impact. The Fed raised rates another quarter in December 2016 and appears to have lifted the seal. With plans for a large stimulus package and tax cut by the incoming Trump administration, there is hope interest rates will rise at a quicker pace.

"For a firm like us, interest income is a huge component; it drops right to the bottom line, it would be a significant boost to us and the industry," says Bartleman.

"We are very hopeful that interest rates increase over time, but would not want to see a rapid change because that would not be good for the overall economy," Corcoran says. "Obviously any increase in rates is helpful to the FCM community."

While the election surprise was good for volatility, as is the prospect of a more accommodative regulatory environment and higher interest rates, one not so welcome outcome of the election is potential restrictions on trade.

"Our customers export a large part of their core crop," Kadlec says. "A certain percentage of their revenue comes from international trade so anything that would disrupt that, I am against. We should have good and equitable trade deals. International trade has kept inflation low; it is excellent for the vast majority of customers on our books."

Corcoran adds, "Certainly if there were trade wars related to commodities that would affect grain and cattle. It could be a positive impact because it could create uncertainty and volatility. However, it could be negative because it would diminish trade."

While no one looks forward to a trade war or continued political upheavals, brokers are becoming more internationally focused and able to operate across jurisdictions. "Brexit could be good or bad, but we do not know yet," Courbebaisse says. "It could create opportunities to create arbitrage across (borders). We have a strong presence (18 countries); we have a strong presence in London, France, New York, Canada, Tokyo; all the way around the world. We are prepared to react to change."

2016 Rank (As of Oct. 31)		2015 rank	Customers' Seg Required (mln.$) [1]	2015 Customer seg required (mln.$)	Excess Net Capital (mln.$) [2]	Customer Amount Pt. 30 Required (mln. $) [3]	Customer Amount Cleared Swap Seg Required (mln. $) [4]	Registered As	DSRO	Retail/Institutional	Managed Funds (Y/N)	OTC (Y/N)
1	GOLDMAN SACHS & CO	1	20,712.12	24,409.91	15,166.93	10,384.72	3,930	FCM BD SD	CBOT/NFA	I	N	Y
2	JP MORGAN SECURITIES LLC	2	18,101.64	18,087.97	13,296.33	3,969.78	9,193	FCM BD SD	CEI/NFA	I		
3	SG AMERICAS SECURITIES LLC	3	15,324.04	13,847.22	2,772.98	3,769.37	294	FCM BD	CME	I	Y	Y
4	MORGAN STANLEY & CO LLC	5	14,053.83	12,506.10	7,506.41	4,128.17	13,183	FCM BD SD	CME/NFA			
5	MERRILL LYNCH PIERCE FENNER & SMITH INC. [5]	4	12,976.35	13,597.55	10,872.37	3,716.29	5,845	FCM BD	CBOT	Both	Y	
6	UBS SECURITIES LLC	6	8,413.03	8,650.62	2,968.07	4,537.23	804	FCM BD	CBOT			
7	CITIGROUP GLOBAL MARKETS INC	8	7,789.60	7,142.53	7,898.49	1,720.00	13,657	FCM BD SD	CBOT/NFA	I	N	Y
8	CREDIT SUISSE SECURITIES (USA) LLC	7	5,658.39	8,036.83	10,326.67	2,830.96	11,594	FCM BD	CBOT	I	Y	Y
9	BARCLAYS CAPITAL INC	9	5,015.20	5,888.08	5,412.53	3,269.98	5,201	FCM BD	NYME			
10	ADM INVESTOR SERVICES INC	11	4,459.48	4,065.37	147.13	327.20	0.77	FCM	CBOT	Both	Y	N
11	RJ OBRIEN ASSOCIATES LLC	10	4,170.40	4,079.33	62.32	240.62	0	FCM SD	CME/NFA	Both	Y	Y
12	WELLS FARGO SECURITIES LLC	16	3,106.01	2,179.44	2,333.71	245.89	7,894	FCM BD	CME			
13	DEUTSCHE BANK SECURITIES INC	12	3,064.49	3,795.80	11,410.88	712.21	1,132	FCM BD	CBOT	I	Y	Y
14	INTERACTIVE BROKERS LLC	14	3,045.56	2,539.50	2,940.96	360.34	0	FCM BD	CME	Both	N	Y
15	MIZUHO SECURITIES USA INC	15	2,806.96	2,383.16	298.73	843.18	7.05	FCM BD SD	CME/NFA	I	N	
16	ABN AMRO CLEARING CHICAGO LLC	13	2,795.73	2,839.57	439.02	104.97	0	FCM BD	CBOT			
17	BNP PARIBAS PRIME BROKERAGE INC	19	2,563.62	1,864.85	1,280.74	13.78	8.02	FCM BD	NYME			Y
18	RBC CAPITAL MARKETS LLC	18	2,153.80	2,016.60	1,797.33	134.76	708	FCM BD	CME			
19	INTL FCSTONE FINANCIAL INC	20	2,097.11	2,539.50	68.70	106.42	0	FCM BD	CME	Both	Y	
20	MACQUARIE FUTURES USA LLC	17	1,978.08	2,053.58	116.24	31.80	5.56	FCM	CBOT	I	N	
21	RBS SECURITIES INC	21	1,841.56	1,521.81	2,599.94	10.04	0	FCM BD	CBOT			
22	E D & F MAN CAPITAL MARKETS INC	24	1,539.06	956.74	65.21	118.83	1.47	FCM BD	CME			
23	ROSENTHAL COLLINS GROUP LLC	22	1,346.66	1,448.29	25.10	19.91	0	FCM	CME	Both	Y	N
24	HSBC SECURITIES USA INC	23	1,273.07	1,111.30	90.53	158.15	770	FCM BD	CME			
25	BNP PARIBAS SECURITIES CORP	26	1,014.81	875.13	1,378.05	133.72	766	FCM BD	CBOT			Y
26	MCVEAN TRADING & INVESTMENTS LLC	25	731.63	896.86	11.81	0.00	0	FCM	NFA	Both	Y	
27	WEDBUSH SECURITIES INC	27	724.70	632.13	135.62	23.02	0	FCM BD	CBOT			
28	ADVANTAGE FUTURES LLC	29	546.56	484.25	11.17	31.90	0	FCM	CME	Both	N	Y
29	SANTANDER INVESTMENT SECURITIES INC	NA	529.34	447.39	134.24	0.00	0	FCM BD	NYME			
30	TRADESTATION SECURITIES INC	30	516.67	489.14	69.32	28.55	0	FCM BD	CME	Both	N	

FOOTNOTES

[1] This represents the total amount of funds that an FCM is required to segregate on behalf of customers trading on a designated contract market or derivatives transaction execution facility. This is the sum of all accounts that contain a net liquidating equity.

[2] Excess net capital is adjusted net capital, less the firm's net capital requirement.

[3] This represents the amount of funds an FCM is required to set aside for customers who trade on commodity exchanges located outside of the United States.

[4] This represents the amount of funds an FCM is required to segregate for customers who trade cleared swaps.

[5] Merrill Lynch, Pierce, Fenner & Smith Inc. includes Merrill Lynch Proefssional Clearing Corp.

Source: CFTC

NEW WORLD OF OPPORTUNITIES & RISK

Many FCMs have emphasize expansion into Asia and are seeing results. "The global markets are still growing. We are working hard on connectivity to provide U.S. futures clearing to entities in China and FCMs in the greater part of Asia," Kadlec says. "The ultimate result of Dodd-Frank emphasizing clearing is still taking hold and that is a positive thing for the futures market. It takes years for culture to change." The formerly faint but growing sound we hear from FCMs this year is optimism. "If we start to see some relief in the [regulatory] cost pressures combined with increased interest rates, we [can] focus more on growing the business and providing innovative new services for our clients," says Gordon.

Corcoran adds, "We are hopeful that the economics of the world are going to change. We hope the U.S.-led economy is going to see higher GDP, and that this will have a ripple effect throughout the world. Europe needs to become healthier. We believe there should be a good reason for markets to trade aggressively in 2017."

Bartlemen sees opportunity if the industry works together on its challenges: The fee structure, pricing, the tick sizing, finding ways to make it easier to trade. "There is a big opportunity to grow this space. You saw this in the election. The futures market was going crazy and you could trade 24 hours. When those election results were coming out, if you weren't trading futures, you were not participating until it was too late the next morning. There are great benefits if we could all work together to get the structure right and penetrate a much broader audience," he says.

This is a much more optimistic view.

"The challenges will continue to be price competition, and the investments in technology and compliance. You can add cyber crime," Corcoran says. "The futures industry is extraordinarily complex and global, and can be overwhelming, but from a business point-of-view it's pretty simple; you need to have a risk-adjusted rate-of-return on capital. And you have to keep your risk manageable and monitored."

Recent challenges have tested the FCM community and it appears stronger for it.

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