DERIVATIVES

Growth of futures market set to continue

BY **KUEK SER KWANG ZHE**

The futures market in Malaysia has grown considerably in the past five years and it is something not many people are aware of. This growth is expected to continue, spurred by technology and new product offerings, says Azila Abdul Aziz, CEO and head of listed derivatives at Kenanga Deutsche Futures Sdn Bhd.

The trading volumes of Crude Palm Oil Futures (FCPO) and FBM KLCI Futures (FKLI) on Bursa Malaysia Derivatives have grown at a compound annual growth rate of about 15% over the past five years, according to Azila.

"Last year alone, there were 14 million contracts traded, which translates into RM858 billion in trade value. This compares with six million contracts traded in 2010, valued at RM114 billion," she says. The FCPO and FKLI are the most traded futures products in the country.

Azila, who is president of Malaysian Futures Brokers Association, says open interest in the futures market shows that it is not a speculative market that can cause high volatility. "Of the 14 million futures contracts traded last year, 2.3 million were open interest. The ratio is six to one, showing that it is a healthy market. This is unlike some overseas exchanges, where the number of open interest is very small but the trading volume is huge," she adds.

Open interest means the total number of open or outstanding futures contracts on the market. Market participants who establish a trading position (long or short position) and keep the position open over a given period of time are considered to have open interest.

Market participants with open interest are usually those who want to hedge their investments when the markets are volatile or companies that intend to lock in the future buying or selling prices of raw materials. In contrast, speculators make intraday trades to bet on the short-term price movements of futures contracts. They buy and sell contracts within a short period without establishing a trading position overnight or keeping an open interest. Thus, the higher the number of open interest, vis-à-vis the trading volume, the less speculative the market.

Azila is optimistic that the futures market will grow at the current pace over the next five years to reach a trading volume of about 22 million contracts per year. While this is a far cry from the top futures exchanges globally, there is still room for improvement at Bursa Malaysia Derivatives (BMD), she says.

Azila believes the volume will rise when market players, including fund houses and retail investors, are more aware of what the market can offer. "More foreign players are expected to come on board as the trading volume increases," she says.

Malaysia is ranked 39th among the top 50 futures exchanges globally in terms of trading volume, based on a survey by the Futures Industry Association that was published last year. The association is one of the leading global trade organisations for futures, options and centrally cleared derivatives markets.

The top five futures exchanges are the CME Group, Intercontinental Exchange, Eurex (headquartered in Germany, dealing primarily with European-based derivatives), National Stock Exchange of India and BM&F Bovespa (São Paulo, Brazil).

"In aggregate, the top five exchanges account for 10 billion contracts traded per year. The average trading volume of the 50 exchanges is 500 million contracts. We are now only at 14 million, but we are getting there," says Azila.

GROWTH DRIVERS

Technology and new product offerings will be the next growth catalyst for Malaysia's futures market.

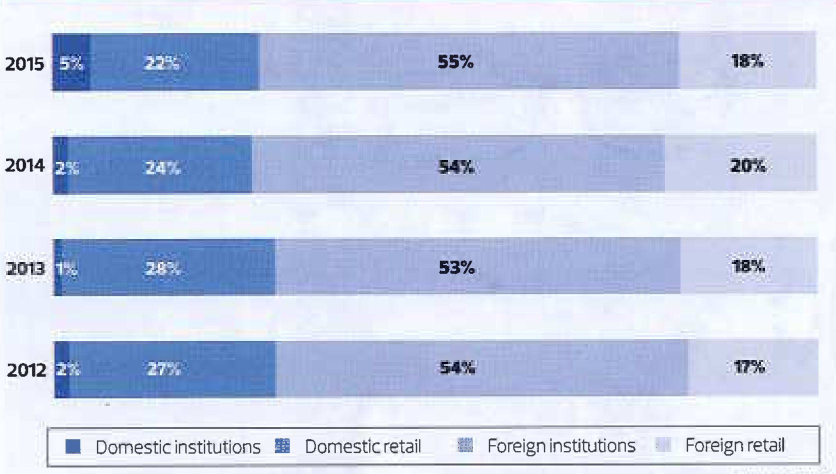
Azila notes that with fintech firms adopting blockchain technology, investors and traders could easily open brokerage accounts with several brokerage firms using a single chip. This compares with the traditional way of filling up futures account opening forms, one after another. These documents are then manually submitted to related parties such as banks (where funds are deposited to settle the variation of margins) and be processed over time.

"Let's say you are a retail customer and you want to open an account with Kenanga Deutsche Futures and CIMB Futures to trade on both platforms and use two solutions. What you do now is come to Kenanga, provide us all the necessary details and fill up all the documents to open an account with us. Then, you go to CIMB and do that all over again," says Azila.

"But with the blockchain technology, all the relevant information involved in KYC (know your customer) procedures can now be obtained by all other brokerage firms via a private distributed ledger that is accessible to them. The banks will also refer to the private distributed ledger to verify your information. This is envisioned to boost efficiency in the market and reduce cost and time."

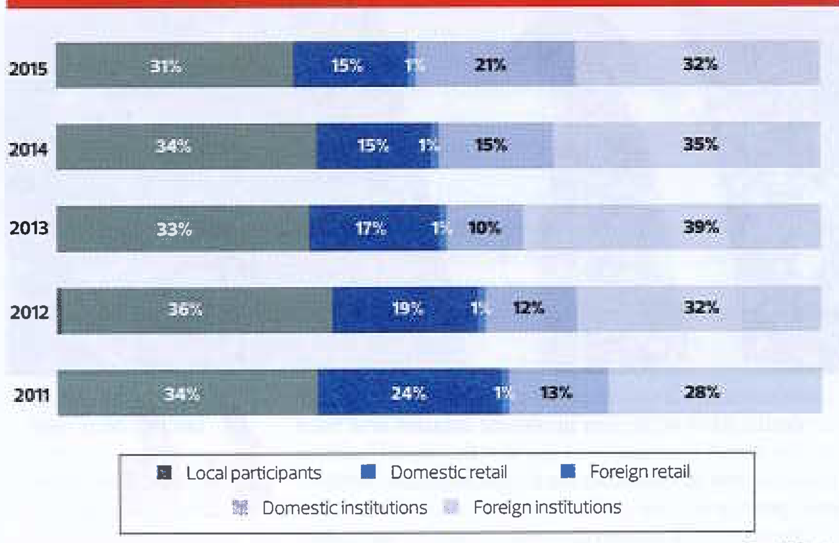
Blockchain technology has sparked many discussions in global futures markets and it is believed that it will happen in Malaysia sooner or later, says Azila. "On a higher level, we envisage a major shift in the payment and settlement process, brought about by technological advancements."

Breakdown of investors of FBM KLCI Futures



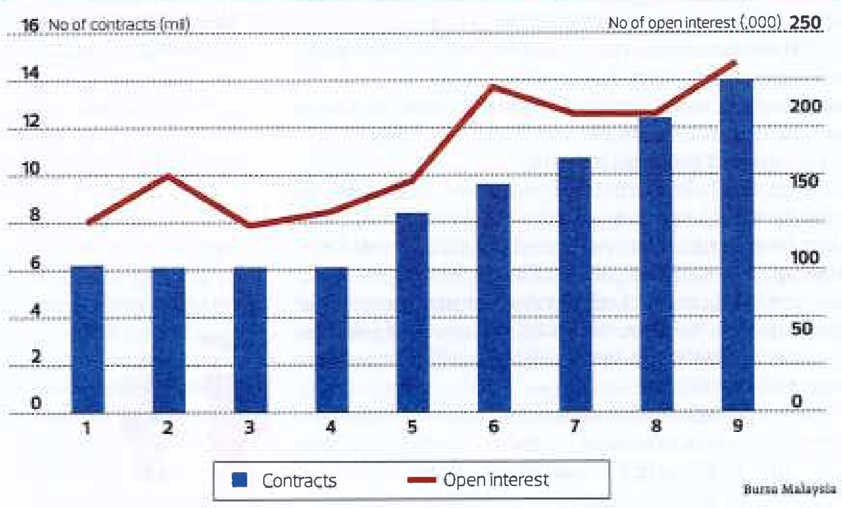
Bursa Malaysia

Breakdown of investors of CPO futures



Bursa Malaysia

BMD trading volumes & open interest



Bursa Malaysia

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Azila, who has been in the futures industry for many years, is a big believer of technology changing the marketplace. She has witnessed how the local futures market has evolved in recent years because of new technology.

The futures trading system transformed from an open outcry system in the 1990s into an electronic trading platform in 2003. Then, market direct access was kick-started, where not only brokers and traders could execute futures trade orders using the automated platform but retail investors were also allowed to open a brokerage account and trade futures contracts on their own.

The average trade volume under the open outcry system was 700 to 1,000 contracts per day. The volume rose 10 times to 7,000 contracts when the trading system was automated. And when the direct market access began, the trading volume went up to 14,000 contracts and open interest reached more than 100,000.

"Technology always brings change. It is unavoidable as more millennials enter the market. They are savvier and tend to get things done virtually," says Azila.

Regulators, which play a crucial role in protecting the rights and benefits of the public and helping the futures market grow, should understand this and find a balance between regulation and innovation, she says. "Everything is moving so fast today. Fintech advancement must be balanced with the need to comply with regulatory requirements. And the regulators have to find a solution for technology changes and strike a balance between the two."

E-MINI CONTRACTS TO SPUR TRADING VOLUME

New product offerings such as the e-mini futures contracts could attract even more retail investors, says Azila.

E-mini contracts function like convertible warrants. They are smaller contracts than the mother contract and are denominated in the same currency. E-mini contracts can be converted into the mother contract depending on their size. For instance, two e-mini contracts worth RM1,000 each could be converted to a mother contract worth RM2,000.

Based on information online, the e-mini contract concept was introduced by the Chicago Mercantile

SAM FONG/THE EDGE

Futures Industry Association top exchanges for 2014 (published in March 2015)

RANK	EXCHANGE
1	CME Group
2	Intercontinental Exchange
3	Eurex
4	National Stock Exchange of India
5	BM&F Bovespa
6	Moscow Exchange
7	CBOE Holdings
8	Nasdaq OMX
9	Shanghai Futures Exchange
10	Dalian Commodity Exchange

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Exchange in 1997 as the existing S&P 500 index futures contract size was too large for smaller traders. Back then, an S&P 500 futures contract was valued at US$500,000 and the first e-mini contract was five times smaller than the mother contract. The e-mini contract was later split in the ratio of 2:1, valuing it at US$250,000 per contract.

E-mini contracts have taken off and are now one of the largest trading vehicles in the world. They have the advantages of high liquidity and affordability for individual investors. They also have a lower margin requirement than the mother contract.

Azila says the current CPO and index futures contract sizes are fixed by BMD, based on research before they are rolled out. But she does not discount the possibility that the exchange could come out with smaller futures contracts if they can attract retail investors to participate in the market.

Meanwhile, gold futures and index futures contracts are two products retail investors could look at, says Azila. The initial margin to trade a single gold futures and index futures contract is RM1,000 and RM4,500 respectively. The Single Stock Futures contract, which trades 1,000 shares per contract, is another product that retail investors could explore.

Azila says retail investor participation in the local futures market is still low compared with other countries such as South Korea. This is mainly due to the negative perception retail investors have about futures, she adds. "It is the same old concern — that futures are extremely risky and dangerous. But why not look at the benefits of the products and understand the risks?"

She says instead of seeing futures as a taboo, investors should accept the fact that futures trading is risky but also offers the potential of high returns. The risks involved can be mitigated by learning technical analysis and the fundamentals of the underlying assets.

Investors should have a good understanding of the products and approach brokerage firms licensed by regulators, instead of trading futures through bucket shops, she says, referring to unlicensed brokerage firms that lure people to trade securities with them using various tactics.

Other benefits investors could gain through trading futures include leveraging the investment capital, hedging the investment portfolio through long or short positions and lower commissions. E

CONCERNS ABOUT HFT FIRMS

Besides technological advancements and a gradual increase in the awareness of futures trading, another reason for the growth of the futures market is the migration of Bursa Malaysia Derivatives' (BMD) matching engine to the US six years ago.

In 2009, BMD entered into a strategic partnership with US-based CME Group, one of the largest options and futures exchanges in the world. CME took up a 25% stake in BMD and the latter's matching engine was migrated to Chicago the following year.

This means all bids and offers on Malaysian futures products are matched through the Chicago Mercantile Exchange's (CME) Globex platform, which is one of the fastest global electronic trading systems for futures and options in the world. Foreign players, by registering with local brokerage firms, are able to trade BMD's products directly through CME's global network.

Foreign players include banks, hedge funds and high-frequency trading (HFT) firms. This has made the Malaysian futures market more vibrant and diversified as more trading strategies are deployed in the market, says Azila Abdul Aziz, CEO and head of listed derivatives at Kenanga Deutsche Futures Sdn Bhd.

However, the number of foreign HFT firms are causing some concern among local futures traders. "A few of them, including directional traders and spread traders, told me that there had been cases of front running in the past two years," says Yong Chen Chook, founder of Straits Index Sdn Bhd, a proprietary trading firm licensed by BMD.

In the context of HFT firms, front running means these firms use computers programmes that allow them to trade futures contracts extremely fast and earn a small profit from each contract by selling it to the buyer. As a result, the buyer — which could be an institutional or retail investor — would have to buy the futures contracts from the HFT firms at a slightly higher price. That is because all other futures contracts in the market the buyer intended to buy would have already been bought by the HFT firms using their high-speed computers and trading algorithms.

The HFT firms came under the spotlight in 2014 when *Flash Boys: A Wall Street Revolt* was published. The book, written by Michael Lewis, says the US stock market was "rigged" by HFT firms that engaged in front-running orders placed by investors. The book, of course, attracted the attention of the regulators.

On the flip side, a view is that HFT firms provide huge liquidity to the market. Currently, about half of the US equities trading volume comes from these firms. Supporters of HFT also say the practice has lowered the cost and tightened the spreads of stocks, which have benefited investors.

Azila, talking from the perspective of a brokerage firm, says the participation of HFT firms running quantitative-based arbitrage strategies on Malaysian futures market is on the rise. However, the participation rate of these firms are much lower than in other developed futures exchanges, where HFT firms take up 40% to 50% of the total market volume.

"In Malaysia, the statistics pale in comparison as HFT firms only account for a modest percentage. In this context, there is no significant concentration of risk from a single type of client given the diverse composition of exchange participants, which includes hedgers, arbitragers and directional traders," she says.

The Malaysian futures market has not been the focus of HFT firms because its trading volume is not as high as those of top futures markets.

"We need to educate our clients. We have spoken to clients of HFT firms that want to run very large programmes and they want to run the same for Malaysia. I say this is a smaller market. We are trading 14 million contracts per year, compared with soybean futures, for instance, which is about 100 million contracts per year," says Azila.

"They can test some of their strategies here and see if they work. If they can make some money here, they will do so. But if the market is too small, they won't."

On top of that, these proprietary HFT firms or those that operate under foreign investment banks have to be certified by CME before they can trade on the Malaysian market. Following that, these firms have to establish relationships with local brokerage firms and be subjected to the surveillance of BMD and local firms.

"These firms have to be CME-certified and follow the rules of the exchange. So, you can't simply engage in front running — you will be detected," says Azila.

"It is also a regulatory requirement for an HFT firm to establish a clearing business relationship with an onshore broker before access [to trade in the Malaysian market] can be allowed. The onshore broker then sets a value in trading limit and monitors the clients' positions in line with the limit prescribed by BMD. Brokers would also have to ensure compliance to safeguard market integrity and orderliness."