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INDUSTRY PUSHES FOR FASTER RISK CHECKS IN A POST-NAKED ACCESS WORLD

BY PETER CHAPMAN

With the Securities and Exchange Commission expected to soon ban the practice of “naked access,” vendors, exchanges and brokers are scrambling to speed up their risk management technology.

Trading infrastructure vendors such as FTEN, Mantara and Bon Trade Solutions and exchanges like NYSE Euronext and BATS Exchange are in a race to develop and promote their risk monitoring capabilities to potential clients—namely broker-dealers and hedge funds involved in the business of high-frequency trading.

Brokers themselves are either making their processes run faster and more efficiently or evaluating the offerings of the vendors.

It's all happening because the SEC wants the industry to check each and every order before they are sent out to make sure they aren't erroneous or oversized.

“There needs to be more risk control than there has been,” David Gilbert, president and chief executive of Mantara, told Traders Magazine. “The tools are there to do that.”

On Jan. 13, the SEC proposed a new rule that would require broker-dealers who permit their customers to trade directly in the markets under their names to vet each order on a pre-trade basis. If approved, the rule would effectively bar unfiltered, or naked, access, which accounts for a considerable amount of volume.

The largest providers of naked access are expected to push the SEC to except the orders of their broker-dealer clients, arguing they are already strictly regulated. Still, most trading officials expect the rule to pass without exceptions.

If that is the case, the ruling will open the sponsored access business up to new players and require naked sponsors to incorporate risk checking. In either case, players will need a high-speed trading infrastructure coupled with risk monitoring software.

“The big firms want the business and they are trying to figure out how to get it,” Gilbert said. “But they don't have the technology platforms themselves. We are in discussions with some of the major organizations who don't have the capability to do this.”

Up until now, many high-frequency trading shops have opted for naked access because it was faster than going through myriad risk checks. Now they must resign themselves to the possibility of slightly slower trading speeds as their orders pass through possibly a dozen checkpoints.

That's why the efficiency or speed of the risk-checking software has become the highest priority and greatest concern in the high-frequency trading community. Because the quest for speed, or low latency, is as important as the quality of its trading strategy, a high-frequency trader who flies through the risk checking process will have an advantage.

“As long as my tool is better than the FTEN equivalent, or something like that, then I am fine,” Matthew Gray, chief executive and managing member of high-frequency shop Simplex Investments, said at last month's TradeTech conference. “A value-added tool will put me at a competitive advantage.”



David Gilbert,
President and CEO, Mantara

FTEN, a trading infrastructure vendor, is known for its risk monitoring software. It has built its success by working with the prime brokerage divisions of major banks to transport HFT orders to the markets. Many of them are also FTEN investors.

FTEN competitor Mantara boasts its risk checking is the fastest, taking only 7 to 8 microseconds to put an order through 12 checks. The whole process, according to Gilbert, takes less than 100 microseconds. The executive estimates an order spends between 60 and 85 microseconds inside Mantara's order manager.

“There are very few firms who can get close to that performance with or without risk control,” Gilbert said. Among the variables checked by Mantara's software are a trader's buying power, symbol concentrations, and dollar and quantity limits.

The exchanges are not sitting on the sidelines. They have also begun to roll out risk-monitoring technology. BATS Exchange was one of the first. Last April, it gave its sponsoring members, in real time, the ability to block or cancel orders, limit or restrict order sizes, and manage easy-to-borrow and restricted stock lists.

NYSE Arca is doing something similar. “We're putting a client management GUI in the hands of customers so they can manage sponsored access,” Paul Adcock NYSE Arca's head of trading operations, said at an industry conference earlier this year. “It will give them all the statistics on orders and positions.”

Brokers are gearing up to court high-frequency traders as well. Many have been largely shut out of the business because they wouldn't allow HFTs to use their MPIDs without risk checks. Clearing firms such as Wedbush Morgan and Person Financial, which offered naked access, grabbed much of the business.

Now full-service brokers are jumping in. Nomura Securities International is an example. The big Japanese broker already offers a filtered market access service collocated at the Tokyo Stock Exchange. It plans to roll out a similar service in the U.S. by the summer.

“We are in the process of building low latency exchange access technology that we will co-locate at the major exchanges,” said Amit Manwani, Nomura's head of quantitative and analytics products in the U.S.

“We believe it will give our trading desks and our clients similar latency and throughput they currently get from sponsored access. It won't be naked sponsored access, though. We will institute rigorous pre-trade risk and compliance checks. We will be able to shut client strategies out in real time if we feel that someone is violating certain risk parameters. It will be the best of both worlds.”

Nomura plans to validate orders during the routing process on a pre-trade basis. According to Manwani, Nomura's risk checks will prevent offending orders from reaching the exchange without sacrificing on latency and performance.

