

SECURITIES INDUSTRY | **NEWS**

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NYSE Slaps Fat Fingers With Checkpoint For Filtering Orders

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With the rise of high-frequency trading come thousands of orders a second and 13 million or more a day--from a single firm. With such unprecedented use of microseconds--where scenarios are calculated, strategies determined and orders made all in less than the blink of an eye--never before has risk management been more crucial to the health of the marketplace.

One single error--an accidental push of a button or click of a mouse or faulty algorithm--could easily wreak havoc.

To help protect customers against such "fat fingering" mishaps, the commercial technology arm of NYSE Euronext plans to launch a risk filter by the start of October that helps a broker monitor and supervise the trading activity of market participants it sponsors.

A risk filter such as this is needed to guard investment banks such as Morgan Stanley, Goldman Sachs and others from the risks of giving their clients direct access to an exchange, when they sponsoring their connections. NYSE Technologies' plan to create such a risk filter was disclosed in a filing made with the Securities and Exchange Commission in December and approved in February.

The filter, dubbed the Risk Management Gateway (RMG), is slated for release to all users within the next 30 to 60 days. Upon launch, the user fee will be set at \$3,000 per month for the first connection and \$1,000 per month for each additional connection to the RMG. Currently, NYSE Technologies is recruiting a second round of beta customers, but has not identified any of the test clients to date.

"The motivation behind building out the RMG is to effectively provide an exchange facility service that allows our customers, the sell side firms, to connect to their customers in a way that fulfills anticipated regulatory requirements and agrees with what we think is a safe and orderly way to operate that function in the marketplace," said Murray White, senior vice president of NYSE Technologies.

"The RMG gives you additional automated risk management layers for your sponsored access clients," said Keith Bliss, senior vice president at institutional brokerage and NYSE member Cuttone & Co., which offers sponsored access into the exchange. Because Cuttone's mnemonic--a unique identifier for each member firm tagged on the audit trail of all trades--is on those transactions, "we technically hold the risk for anything that would go wrong."

Cuttone conducts an inordinate amount of vetting for any client the firm gives sponsored access, he notes. "We're comfortable with our own process and procedures, but the risk management software will be a nice addition to layer into those protocols," Bliss said.

If the order is consistent with the order size, credit limit and other parameters set by the sponsoring member organization such as Cuttone and any other stock exchange member who can sponsor access into the exchange, the order would be permitted by the gateway to continue to the exchange's trading systems. If not, the gateway would return the order to the sponsored participant. The gateway would only interact with a Sponsored Participant's order prior to its receipt by the exchange's trading system.

Magnified Impact

Once the filter is launched, NYSE Euronext will decommission the ADOT, Anonymous Designated Order Turnaround application--a previous generation of a similar, very "limited use" alternative gateway--that a few member firms were previously using, according to White.

Such a risk gateway would have prevented the fat-fingering that took place in Japan in late 2005. That's when Mizuho Securities, one of Japan's largest brokerages, lost \$344 million when it could not cancel a bad trade on the Tokyo Stock Exchange, said Sang Lee, founder and managing partner of Boston-based research firm Aite Group. A risk gateway would have flagged the faulty trade before it hit the market.

"There is always the probability of mistakes like this happening, whether it is completely automated or someone tapping on the keyboard, it is still human initiated, and there is always going to be a chance for error," said Lee. "The concern is that as the markets become increasingly electronic some of this may trigger activity that may potentially magnify the negative impact that it may have in the market place ... when everyone is taking about millisecond execution turnaround time, once you click it, you're done."

NYSE Euronext is not the only exchange operator with its own pre-trade risk management mechanisms in place. The Chicago Board Options Exchange, for example, has three categories of checks to help prevent users from entering potentially erroneous orders, including routing an order for manual handling if it is greater than the selected order size and rejecting complex orders that appear to be reversed, according to a CBOE spokesperson.

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Beyond what exchanges provide customers in terms of risk checks, third-party software vendors such as New York-based FTEN also provide risk filtered gateway technology to sit in front of the markets. The New York firm, which claims that its technology is used to process more than \$100 billion of transactions every day in U.S. markets, serves prime brokers who handle trades for hedge funds and other proprietary trading firms.

Proper Message

FTEN founder and CEO Ted Myerson said NYSE's RMG offering "sends the proper message that exchanges are providing this type of limited risk functionality." For his eight-year-old firm, however, successful risk management comes down to catching errors before they even make it to the exchange.

While an exchange offering its own risk management solution can only help the market, "it can only go so far because they are one exchange of many in the market place," argued Myerson. "At the order level, you are not only A, a silo, but B. You're only getting part of the picture, and you are only able to control a small piece of the picture when it comes to risk management."

That's where FTEN steps in, said Myerson. "We view the market as a whole, on the order and account level, and once you step out and see that, you are talking about true, real-time risk management. You don't know anything else about the history. Because high-frequency traders can send several hundred or

thousand messages a second, you need to be combining the order level and account level into one real-time risk system."

Account level monitoring is important because when an order is sent to the market, the exchange can only check if the order meets the parameters based on that symbol and the volume of how many shares they are buying or selling, he explained.

"I see many of the exchanges trying to come out with their own solution to address the challenges that center around regulation and the growth of high frequency trading," said Myerson. "[However], you don't want to put in a control to check a box-- you want a control that is going to protect you and your client while meeting across-the-market needs."