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Checking the Unchecked – How a Key Market Access Rule Laid the Foundation for A Stronger Financial System

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To commemorate the 20th anniversary of Fidessa's presence in the US, we are proud to present the latest in a series of articles looking at some of the key industry and regulatory events that have helped shape the trading landscape since the opening of Fidessa's first US office in New York some two decades ago.

The growing risk that unchecked exchange access posed to the financial system drove the SEC to issue an important rule governing market access in late 2010. Uncertainty around the implications of that rule, 15c3-5, presented some early challenges, but what ultimately emerged was a framework of controls that improved the resiliency of stock markets. Douglas Craig, Senior Product Manager at Fidessa, discusses how the industry managed the new regulation and how it ultimately helped strengthen the integrity of trading.

The shift to electronic trading in the 90s and early 2000s made it possible for buy-side firms to connect directly to stock exchanges, via sponsored brokers, without the need for human interaction. In turn, this electronic access encouraged the development of intelligent algorithmic and automated trading strategies. However, as trading evolved to offer substantial advantages to the technologically savvy, questions were raised about whether the financial industry could manage the risks inherent to this direct and automated market access.

The biggest alarm came through the lack of oversight afforded by the 'naked access' model of connectivity. 'Naked access' allowed buy-side firms to use a broker's exchange memberships to send orders directly to the market, bypassing the broker's pre-trade risk checks and controls. Many market participants preferred 'naked access' because it avoided slowdowns that could come from routing orders through a broker's system. This bypassing of controls and checks heightened the risk that an erroneous trade or manipulative trading activity would wreak havoc on the increasingly interconnected and automated financial markets.

By the time the 'Flash Crash' of May 2010 awoke the world to the dangers of unfettered market access, the SEC was already on the move. Earlier that year, the regulator had proposed new rules that required any broker with market access – including those that sponsored a buy-side firm's access to an exchange – to implement adequate risk management controls and oversight, effectively eliminating naked access. The Flash Crash only accelerated the SEC's efforts and by November 2010, SEC Rule 15c3-5 was in effect.

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Initial uncertainty

When released, this regulation offered general details on what the SEC expected from brokers. The rule mandated policies and procedures geared toward implementation of 'appropriate' risk controls across the firm. What the SEC's issuance was short on, however, was clear definitions of what these new controls and procedures were supposed to be. Like much of the trading regulation passed over the last decade, the mandate was for policies and procedures, not prescriptive solutions, and was subject to a firm's interpretation.

Understandably, there was a considerable amount of confusion in the industry at first. Firms were afraid of pouring lots of money in a framework that wouldn't pass muster with the SEC. But the bigger conundrum lay in the little details that firms would have to figure out themselves: "What is the appropriate level for each of the new checks? Could I filter a client's orders through an exchange's risk checks instead? What if a big client comes in with a massive order – can I adjust my limits? How can I implement these controls but still reduce or eliminate risks to my revenue, client relationships, and overall business?"

Alongside this, the elimination of naked access suddenly opened up the playing field for smaller brokers. Prior to 15c3-5, order flow originators favored the few major brokerages that offered naked access. With naked access no longer in play, some brokers found themselves able to compete for this order flow by offering their own electronic trading capabilities. In quick succession, a new market and revenue stream was available, and the trading world became a bit more democratized.

Helping customers find clarity

Successfully navigating customers through the rule proved to be one of the major milestones for Fidessa's US operations. The challenge was two-fold: interpret the SEC's guidance to create an operational model that would satisfy regulators and support clients of all shapes and sizes, and evolve its software in a way that delivered the necessary functionality and flexibility, in as simple a manner as possible.

Collaboration took center stage in the development of this new functionality. Internally, Fidessa tapped its wealth of global experience in addressing regulatory change to shape a concrete set of specifications. Externally, the company took great care to provide clients with a transparent roadmap and guide to compliance, updates on how the system would take shape and a channel to provide regular feedback.

The resulting software was developed with extensive functionality, and more than enough flexibility for brokers to adapt risk controls and workflows to suit the nature of their trading business, such as setting different limits for order flows generated from human brokers versus direct market access flow versus algorithmic flow.

Fidessa also facilitated the entry of many small and mid-sized brokerages into the electronic trading space during this period. These brokers, sensing the opportunity to capture market share from the major firms, turned to Fidessa for the algorithmic support and technological scalability needed to handle greater and more diverse flows. As a result, these brokerages were able to exploit this opportunity and expand their services in a cost-effective manner.

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The impact of the Market Access rules today

Six years later, Rule 15c3-5 is just one piece in a broader regulatory framework designed to curb erroneous and illicit orders. Newer controls, like the limit up-limit down mechanisms, help exchanges limit the effects an erroneous order could have on the financial markets. Manipulative practices, such as spoofing, layering and front-running, have been banned outright. Alongside these buffers, 'Market Access' rules continue to play a crucial part in ensuring the integrity of orders before they hit the market, and restoring investor confidence in the markets.

With this framework in place, the financial markets have been more resilient in the face of major economic shocks. One only needs to recall the relatively seamless operation of stock markets during volatile events like Brexit to see this in practice. And yet, the constant evolution of the financial markets poses new challenges. The ETF 'Flash Crash' of 2015, where the price of many ETFs became vastly decoupled from their underlying investments, shows that controls are far from perfect.

As new rules and trading methods reshape the ways financial institutions access stock markets, Fidessa continues to stand at the forefront of technology, intelligence and client collaboration. In this context, one could expect Fidessa's next 20 years in the US to look a lot like the last 20: continuing to build dynamic client-driven solutions while guiding brokers, traders and others through groundbreaking, complex, and ever expanding regulatory change.

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