

## Tech Providers Asked to Step Up Games

Vendors adapt as trading shops and investment firms need to speed up *and* slow down

**T**rading is rapidly evolving, the recovery in the financial markets is showing signs of faltering, and substantial financial regulation seems a near-certainty. With that tumultuous backdrop, firms that sell software and technology to trading shops and investment companies are facing a multitude of increasingly complex challenges in their mission to get, and stay, on customers' desktops.

"This business is very dynamic—the connectivity to exchanges is changing, and there's obviously continued pressure on performance," Martin Leamy, president of the Americas group at Orc Software, told Markets Media. "We really need to stay on top these things and be focused on high performance and low latency. For companies that are trying to do this themselves, it is a real challenge."

The software and technology sector is among the most fragmented on Wall Street, as vendors range from garage-level operators who claim to have built a better algorithm to giants such as SunGard, which can provide soup-to-nuts product suites to a trading desk. The sector's fragmentation also manifests itself in countless niches ranging from high-frequency trading to clearing to compliance, and apples-to-apples comparisons among vendors are hard to come by.

A trading and investment landscape that is often hyper-competitive is prompting customers of vendors to make faster and faster trades at the highest levels of efficiency. At the same time, regulators and clients of the vendors' customers, i.e. end-user investors, are demanding that vendors' customers bolster risk management and provide more transparency. These conflicting signals of speed up,



slow down underscore the difficulties vendors face in finding the right mix of products and services to add value for their customers.

"Today's trading environment is more complex than ever, yet greater transparency and transaction speed are demanded," said Sam Mele, co-founder and managing director of firm58, which makes software that helps trading shops and investment firms boost operational efficiency and cut costs.

The securities and investments industry will spend \$41.6 billion on technology products and services in 2010, almost 6 percent more than 2009 and about in-line with 2008 levels, according to Aite Group projections.

### Does Size Matter?

For vendors, size allows for economies of scale and bundled product offerings that smaller players cannot match, and the increasing complexity of trading and investing can make one-stop shopping more appealing.

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SunGard's MicroHedge unit, told Markets Media. "I certainly hear it from clients who say I don't want all these different apps on my desktop. They have an application for risk, they have an application for execution, they have an application maybe for market making or an (order management system), they have compliance. They would rather reduce. It's too much on their desktop to really make sense of, and from a technology standpoint your support staff has to support all that and reconcile it so it all behaves on the desktop, and that's difficult."

Still, the days of cutting-edge software, algos and trading methodologies being concentrated in the hands of the biggest, deepest-pocketed players are over, overtaken by a democratization of technology that has enabled many nimble "little guys" to compete without having to make huge capital investments. "There are a lot of small players at the garage level who are successful," said Calin Ciordas, a director at Credit Suisse.

Large or small, tech vendors were hurt when as financial crisis of 2008-2009 caused Wall Street to contract and IT budgets to wither. While some measure of stabilization has returned, spending remains off the go-go levels of a few years back.

"The global financial crisis has naturally impacted Fidessa's customer base," said Martin Hakker, managing director at Fidessa, whose "one-stop-shop" connectivity network offers trading execution services. Hakker said Fidessa still has managed to increase its client base, "due in part to increased fragmentation of liquidity and the rising requirements for smart trading solutions with multi-asset, cross-border support."

Lean years have prompted trading and investment firms to more closely scrutinize the cost side, as has been the case with nearly every sector of the economy.

"Everybody will always be concerned with order flow and generating revenue, but I think there has been a new emphasis on managing profit with resources dedicated to reducing expenses," said Mele of Firm58. "Revenue needs to be protected. Detailed management of income and expenses is now more important than ever. Both buy-side and sell-side firms want to understand all of the various expenses that affect net profitability, both transactional and non-transactional."

### Costs Under Microscope

"It used to be that people were looking for top-line growth regardless of the means to achieve that growth. However in today's electronic trading environment, exchange, clearing, regulatory, and settlement fees—to name a few—add up quickly and can significantly impact profit," Mele said.

Aside from a weak economy and financial turbulence, market fragmentation is also pushing players to be more careful on the cost

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side. “A single order now executes on many different execution venues, for example (New York Stock Exchange), Arca, a dark pool like Liquidnet, and DirectEdge, all at the same time,” Mele said. “That single order gets broken down into many transactions which lead to greater overall transaction costs. People have started to take notice of these escalating costs.”

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The lack of standardized post-trade data is another vexing matter for vendors. It “is an industry-wide challenge,” Mele said. “Since there are no standards in the industry for this, aside from some regulatory reporting standards, maintenance of the data is an ongoing challenge.”

Beyond trade data, “the problem gets worse when you consider other forms of data such as invoice information and fee-schedule changes,” Mele said. “There are no standards in our industry for these types of information exchanges, yet there are for essentially every other industry. If we had standards, a lot of the transparency problems regarding fees and commissions in the industry would go away.”

### Financial Regulation Eyed

Vendors are closely monitoring financial reform legislation as it works its way through the halls of Capitol Hill, for its effects on transparency and a host of other matters. There are various proposals under discussion; major thrusts include transparency, pre-trade risk management, central clearing of derivatives, and bank divestitures of prop trading and/or derivatives businesses. Each initiative has its own probability of becoming law and would bring its own implications for the software and tech sector.

“A big issue is how the (financial) industry is going to manage risk in a multi-asset environment, especially in light of high-frequency trading moving outside of equities,” Mele said. “Also, what impact will portfolio margining have—how will new margin rules impact trading and risk management?”

The complexity of the market is a front-and-center challenge facing software and technology vendors, according to Jerry Hanweck, chief executive officer of Hanweck Associates, which sells risk management products.

Another major issue is regulatory scrutiny pertaining to pre-trade risk. “The (U.S. Securities and Exchange Commission) is demanding that any providers of sponsored access and traders themselves, brokers and even exchanges have to do some kind of pre-trade risk analysis,” Hanweck told Markets Media. “As the trade comes in, as the order comes into their system, whether they’re a broker or an

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exchange, they’re going to have to have something—it’s not clear yet what—but something, in place to measure the risk of that order and either allow it through or not. And in the options market, you are dealing with 350,000 different options contracts and two million messages per second right now and extremely high-frequency orders spread across eight or nine different trading venues.

“This becomes a pretty complex technological problem,” Hanweck continued. “This issue will push the limits not just on computation, which is what we do, but also the message handling and the order routing that these guys work with.”

In the wake of the May 6 market “flash crash,” regulators have suggested that revisions to markets’ circuit-breaker mechanisms, which would affect when and how trading is slowed or stopped during periods of extreme volatility. This is just one example of a potential change that vendors will have to account for when developing or updating products.

“Fidessa is addressing the SEC’s new rule to impose a circuit breaker to restrict short sales when the price of a stock declines by 10 percent or more from the prior day’s close,” Hakker told Markets Media. “We are also closely monitoring the SEC’s proposed rules around risk management controls for brokers or dealers with market access, as well as (Financial Industry Regulatory Authority)’s proposal to extend certain national market system order handling rules to OTC stocks. On the buy-side specifically, we are watching rule 2a-7 under the Investment Company Act,” which will restrict investments in money market funds based on quality, maturity, and diversity.

For larger vendors such as Fidessa, the shaping of overseas regulation is another factor that can lead to new business opportunities for first-movers—or sink the market share of those behind the curve. Either way, it’s not just one nation’s regulation to plan for, it’s also how that regulation does or does not sync with regulation of other nations in an increasingly global trading landscape.

“In Canada we are actively involved in the evolution of best-price requirements, commonly referred to as the ‘order protection’ rule,” Hakker said. “In Europe we remain an active part of the dialogue

surrounding (Market in Financial Instruments Directive), and in Latin America we are making changes to address the new Mexican cash market RINO rules, which will eliminate order instruction based on size and introduce things like multiple channels, new order types and a desk compliance officer into the marketplace. In Asia-Pacific, we are diligently tracking the increasing fragmentation resulting from new regulations designed to foster more open markets.”

## Game-Changing Potential

While vendors’ expectations and concerns about the specifics of financial regulation vary significantly, there is some consensus regarding a couple aspects of the process: one, changes will not be signed into law and forced upon the market anytime soon, and two, when new regulation does come to pass, it will be a big deal. “This legislation has the potential of really changing the (financial services) industry,” said Carrick Pierce, president of Derivix, a developer of software for options pricing and analytics.

“Regardless of what passes and when, I don’t think it will have an immediate impact,” Pierce told Markets Media. “A lot of the changes that are being proposed can’t happen overnight in the industry. That’s just not something that’s realistic regardless of what passes. So it will take a little while.”

“It’s wait-and-see at this point,” Hauser of SunGard said on April 30. “There is a lot that they’ve got under consideration and there’s a lot that they’re talking about doing, but I don’t know that from a software standpoint we can really start writing code or readying ourselves for it.”

Uncertainty is not optimal for vendors and their business plans, but at the same time, a lengthy lag time until implementation of regulation, provided regulators get it right, is preferable to a rush job that would need another revision or overhaul not long afterwards.

“There are a lot of things being talked about and I still think this is going to take a lot of time to get sorted out,” said Leamy of Orc Software. “I hope that they take the time and really study it, because it’s extremely evident from the Goldman Sachs interviews (in late April) that there are not a lot of people in Washington that have an in-depth knowledge of this. It is a complex topic.”

“One of the biggest concerns we have is that there might be something that would damage the business and would drive it out of the country. And there are some things that would potentially do that,” for example certain kinds of taxes, Leamy continued.

One specific regulatory initiative known as the Volcker Rule would prohibit banks from proprietary trading, or even owning a stake in an entity that trades for profit. Meant to insulate lending and credit creation from the risks of trading, some observers say the Volcker Rule goes too far and separating banks and trading would dry up

liquidity in some markets.

“We deal with banks and the Volcker Rule says banks can’t have prop trading shops,” Leamy said. “That would have an impact on us and the industry. I think then that things would move overseas, where it gets to be about global rules being implemented.”

## Customer Base Expands

As the saying goes, with great challenges come great opportunities, and the tech vendor universe is no exception. The dramatic evolution of trading processes has forced pension plans, mutual funds and other traditional buy-side players to upgrade their own systems to keep up, creating more potential buyers of algorithm software and connectivity products.

“More of the mainstream trading crowd—traditional buy-side and others with longer holding periods—are demanding access to the same low-latency technology used by high-frequency traders,” said Jose Marques, managing director and global head of electronic equity trading at Deutsche Bank.

Hanweck is also seeing an uptick in intra-sector demand, as vendors of order management systems and execution management systems buy services from other vendors.

“The OMS and EMS, in the past they would either have tried to build it themselves or not done it at all,” Hanweck said. “Now they’re taking what we call analytics as a service, they’re bringing options analytics as a service into their products so rather than build all of the analytics in their systems themselves, they are outsourcing it to our technology. These are groups like Mixit and Portware. In addition, the exchanges, for example the International Securities Exchange—their PrecISE platform, which is really a EMS/OMS platform, they take all their vols and Greeks for the options market from our VoleraFEED product. So rather than building out themselves they just took that as a service.”

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