

The FIA European Principal Traders Association

An interview with Mark Spanbroek

By Mike O'Hara, February 2012



In this interview for the High Frequency Trading Review, Mike O'Hara talks to **Mark Spanbroek**, Vice-Chairman of the FIA European Principal Traders Association (EPTA) [<http://www.futuresindustry.org/epta/>] and a former partner at Getco.

HFT Review: *Mark, welcome to the High Frequency Trading Review. Can we start with you telling us about your own background?*

Mark Spanbroek: Yes of course. I have been active in the business since 1986. Most of my career I traded derivatives on the floor of various European exchanges with Van Der Moolen, where volatility was my thing. In 2002 I joined Getco as a partner to help the company expand. At the end of March 2011 I decided that I wanted to spend more time at home so I resigned from Getco, but I've stayed in the business so to speak through my participation in FIA EPTA.

HFTR: *How did the FIA European Principal Traders Association (EPTA) come about?*

MS: Around October 2010, I got involved in a discussion with some other principal trading companies to try to form a strategy on how to better explain what we do. To cut a long story short, four or five people were at the helm of this conversation and we finally decided that we should form an association to present a consensus view, give us a stronger foothold in Brussels and let the European Parliament know what it is that we are actually doing.

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So we checked around and quite a few firms were interested to join the group, particularly smaller companies with maybe just twenty or so people on the payroll, but who add an enormous amount of liquidity to the market.

So we sat down, we drafted the principles, we reached a consensus and we launched in June 2011 during the London IDX conference. We started right off the bat with 20 companies, and we now have a very widespread member list across Europe, which we want to continue to expand.

We have established a small office in Brussels to create a presence there but that's not our only focus. As EPTA we can join with one of our member firms to visit the regulator and the Ministry of Finance in their home country. In this way EPTA serves as both a local and a widespread European organization. And that's going well. We've had many meetings with regulators across Europe and the reception has been really good.

HFTR: *And you're affiliated with the FIA (Futures Industry Association)?*

MS: Yes. Although we originally intended to be independent, it made a lot of sense for us to join forces with the FIA's PTG (Principal Traders Group) because most members know how successful that group has been in the US. So we made a cold call to the FIA and asked if they had thought about having something similar in Europe. It was the right decision; the whole relationship has been absolutely wonderful from day one. We discuss a lot, we have a very open line of communication, we're extremely positive about the whole relationship and we could never have achieved so much as an independent group.

Just to be clear, our interests are not limited to the futures markets. Our members are active in a wide range of asset classes, including cash equities, exchange-traded funds, fixed income and foreign exchange as well as futures and options. Basically are active in just about any market that is traded on a platform that is open to our type of firm.

HFTR: *One of the issues you must face is the fact that public perception of proprietary and speculative trading -- particularly high frequency trading -- seems predominantly negative. How*

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can the media and the general public be better educated on some of the positive benefits that principal traders bring to the markets?

MS: That's a very good question. First of all I think we, as EPTA, and as individual member organizations, have to do a better job. Every time we speak to a member of the press or a regulator, we need to make sure they understand what we stand for and what we do.

As proprietary traders, traditionally we've never had to go any further than an exchange (and maybe sometimes a regulator) to tell them what we do because we don't have customers. And we don't actually want to serve customers, that's not our business model; our business model is to provide liquidity to the market. So one of the reasons why we have been so slow in getting our message out is because we're not selling anything to a customer.

Generally it's the exchange who is interested in us, not the regulator. We're a customer of the exchange and that's where it basically ends. Prop traders often don't see the outside world, it's not important for them, they're dealing with numbers and data and that's what their life is about. But once you have a significant percentage of the market going through either your company or through your association, you need to be more pro-active. That's what we're trying to do through the EPTA group, spelling out what our members are actually doing and communicating that to the bigger world beyond the exchanges.

Not all regulators are the same however. In Holland for example, we've always had lots of prop traders in the stock options market, so the Dutch regulators know what prop trading is all about. But elsewhere, you have regulators who may not have such a significant market, so you can't blame them for not being as well educated on the topic.

HFTR: *How would you define high frequency trading?*

MS: I personally think that HFT is a misnomer. It's not a trading strategy, it's a name we've been given purely because technology has evolved. We prefer to speak of automated trading or algorithmic trading, which is now done in such a way that you can obviously send more orders to a market place in a given time period. I don't want to generalize too much about what the FIA

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EPTA members do, because they are not all pursuing the same strategies. But one of the most common is the type of continuous quoting that most people think of as market-making. It follows that if the technology allows you to send more quotes to the market, you can scale up your liquidity provision. And if the technology allows you to provide those quotes more rapidly, that allows you to quote at tighter spreads. That's because you know what your risk is at all times, rather than being in a don't-know zone for a few seconds or even minutes at a time.

I always give the example of the old days when if you sent an order from the New York Stock Exchange to the Philadelphia Stock Exchange, it took about 19 minutes or so to get there and another 19 minutes for the order to be flagged back. These days, thanks to technology, we can do this in milliseconds. In that context, it is quite obvious that everyone is a lot better off in today's marketplace.

So this HFT term is really a kind of short-cut way to describe the changes in trading technology that have been adopted over the last 10 years or so, which basically have allowed participants in these markets to automate and accelerate their trading systems. That includes things like more bandwidth in the connections to exchanges, more powerful chips in the computers, better software design, co-location and so on.

HFTR: *What do you think are some of the most common myths and misconceptions about HFT and algorithmic trading?*

MS: What many people do not understand is that reducing the latency of trading is also reducing the risk of trading. In the example I just described, with the order from New York to Philadelphia being exposed for such a long time, you actually increase the risk for the firm that puts that order into the market and that equates to cost. If you minimize the amount of time it takes to trade, your market becomes a lot more efficient and that is reflected in narrower bid/ask spreads. All the evidence shows that algorithmic and automated trading have decreased bid and ask spreads tremendously.

The beauty of making a tighter spread is that risk transfer can take place in a much faster and a much cheaper way, and that is what has created the enormous increase in volumes. People see

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that with a one or two cent spread they can now get in and out very, very quickly compared to the old days, when spreads were ten cents or an eighth or a quarter and they had to wait for the specialist to update his prices. The risk transfer takes place on a highly frequent and much more efficient basis, but people just don't get that because they've never looked into it that way.

Another myth is around HFT creating volatility. Well, we've now seen a lot of reports making it very clear that volatility is not caused by algorithmic trading. In fact algorithmic trading will generally not make money from the tops and the bottoms of the graphs, that's often where an algorithmic trading model gets run over. Also, if you look at OTC products (where algorithmic trading and HFT is not active), the volatility is the same if not higher, and so you can tell very quickly that it's a nonsense argument.

HFTR: *Speaking of risk, one of the things EPTA promotes is firms having risk controls in place to ensure orderly, safe and secure markets. What kind of risk controls should EPTA members have as a minimum and what do you recommend?*

MS: Well, the companies that are directly regulated have to have the necessary risk controls and have to be completely within the boundaries of what the regulator requires. So that's the minimum. Beyond that, it's up to every company itself to decide what additional risk controls they want. One of the things that we are doing is to develop best practices for risk controls for automated trading. The FIA has put out several white papers with detailed recommendations on this. Some of the recommendations are aimed at trading firms, some at the intermediaries and some at the exchanges. And we expect to be putting out more documents like this in the near future. There is a tremendous amount of expertise on risk controls within our membership, and one of our goals is to share that expertise with the regulators and help them develop a better understanding of the risks and better methods for managing those risks.

On the pre-trade side, not knowing where you are is the biggest risk. For example, in case you lose your connection to an exchange, not knowing whether your orders have been filled is a huge risk. So most prop trading firms are very competent in analyzing exactly what their position is once a line goes down or an exchange server breaks down. In fact, they often beat the GCM (General Clearing Member) and the clearing house on that.

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The post-trade side is a whole different ball game. One of the biggest risks a prop group can have is being dependent on one particular GCM, and I believe the number of GCMs out there is currently too small. That's an ultimate risk to the marketplace because if your GCM goes down, you can't trade, you cannot be in the market and the market therefore loses liquidity the next day. We saw that happen with MF Global, for example. Exchanges and clearing houses are making changes in order to allow customers to change GCM overnight, which is an important step to manage this risk, but not all of them have achieved that. So I definitely see that post-trade arena as one of the biggest risks.

***HFTR:** Looking specifically at European regulation, many proprietary trading firms are not currently regulated but as you know, there are moves afoot to change that. How do you think proprietary trading firms should be regulated? Do they even want to be regulated?*

MS: Well, by definition EPTA believes -- and it's in our principles -- that all firms need to be regulated. Most of our members already are regulated but there are some firms out there who do not fall under the regulations because there's simply no regulation for what they do.

So as far as regulation goes, yes we ought to be regulated, but being regulated as a bank or as a pension fund goes way too far because proprietary trading firms trade with their own money. We simply don't have customers. So what we are saying to the people in Brussels is that the scope and scale of the regulations should be related to the functions of the firms that are being regulated. In our case, the primary function is the provision of liquidity, so whatever the rules require, they should not disrupt the liquidity that we provide to the markets.

What many people don't understand is that if firms like the members of FIA EPTA are not around, if they are not sending their quotes into the market, very quickly it will become much more expensive for pension funds and other investors to execute their orders.

If you take everyone back ten or fifteen years and you tell them how important the jobber or the specialist functionality was on the New York Stock Exchange, everyone nods their head. Well basically what electronic trading has done is change the landscape so that everyone can now

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become a specialist. It's not a monopoly anymore, it's open. You don't have to be a specialist for the whole day, now you can be a specialist for just one specific order, which might be aggressive, but you're still putting liquidity in. People have to understand that the functionality of the jobber is actually still around; it's just been turned completely upside down, to a system in which you can choose to supply liquidity per order.

HFTR: *Given that the role of liquidity providers is so important to the market, what's your view on the proposals in MiFID (article 17-3) that algorithmic trading strategies should be obliged to remain continuously in the market during trading hours?*

MS: Well, before I answer that, we've seen several examples in the past, the London and Madrid bombings for example, the Lehman crisis, where our members received calls from the exchanges checking that we were in the market that day. And our members have stayed in the market and have made absolutely sure that their staff, their risk controls and the money behind it all were adequate to maintain an orderly market on those days. Which the exchanges didn't demand but simply asked for, because they expected a lot of turmoil.

For us, the "continuous" wording in Article 17-3 of MiFID is quite a big risk. The Commission and the European Parliament want to make sure that liquidity is guaranteed in the market and we absolutely understand that, but if they want us to be in the market for a full 100 percent of the time, if we can't step back from the market for even one second to adjust our models, then basically we cannot comply with that wording.

So we've taken the position that Article 17-3 should be completely deleted. We are recommending a solution that encourages exchanges and other types of trading platforms to develop liquidity provider schemes under guidelines established by ESMA. That will achieve what we all want, which is to maximize the amount of liquidity in the markets at all times. If they leave the word "continuous" in there, volatility will increase and the bid and ask spreads will widen because liquidity providers will be at risk one hundred percent of the time.

HFTR: *Are you satisfied with the way the dialogue is progressing with the regulators on this? Are they listening to you?*

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MS: Yes, we are absolutely delighted with the dialogue we have with the regulators we speak to, including people at the Commission and people in the European Parliament. But I'd like to see more interaction with the regulators who are not as well known to the industry, because they generally shout the loudest but have less experience in this. I don't need to explain to the FSA what this world is about, they know very well themselves what's going on. But there are other regulators who are sometimes harder to talk to. ESMA is a great organization, they are very open and they love to talk to you but with some individual countries -- and these are not the smallest countries, by the way -- it's very hard to get through to them. They have a very strong view, but they don't want to have the dialogue.

HFTR: *Why is that, do you think?*

MS: Well, part of the reason is that the information that the regulators are getting is coming from institutions whose interests are threatened by the advances in technology that we have been talking about. For example, you can see that some of the loudest voices in the debate on HFT come from people who are running brokerage houses. They want wider spreads so they can cross their business internally, which is much more profitable for them!

Banks are quite often in limbo land about what to do here. Quite a few of them have an HFT desk doing prop trading for the bank. Quite a few have developed algorithmic trading tools for their customers. At the same time, a lot of them run brokerage businesses that benefit from wider spreads. So it's quite common for different parts of a bank to have completely opposing views on HFT.

Our interest at FIA EPTA is by definition to have one central market place where everyone comes together. We want a transparent marketplace, not a wide spread of dark pools and so on.

HFTR: *Indeed, one of the stated aims of the EPTA is to promote transparency. But what do you actually mean by that? How much transparency do proprietary traders actually want?*

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MS: Transparency in our world is not about knowing who your counterparty is; it's about knowing the best price and the depth of the market. For us, transparency means knowing exactly where the price of the underlying is. If you look at the open markets, NYSE Euronext, LSE, Chi-X, etc, that's all transparent, you can see the depth of the markets. But if you look at the fixed income or FX markets, those markets are not transparent and access to the market is very limited. As a result you don't see anywhere near the competition among liquidity providers that you see in the equity markets. We believe very strongly that a lot of progress can be made if MiFID is expanded to cover those markets too.

HFTR: *Other than having Article 17-3 of MiFID completely removed are there any proposed regulations under discussion that the EPTA really does not want to see?*

MS: Well, we're very positive about the MiFID draft as we've seen it now and think that 95 percent is well written and excellent. The point I made about regulation going too far is something we will bring up. There is some language in there where if you're a one-man shop you almost have to act like a bank. That could kill a lot of smaller firms, and smaller firms do in fact put a lot of liquidity into the market. The other one we're trying to get a better view on is what they actually mean by the order-to-trade transactions ratio because we feel that's another thing ESMA can't control. For example, products such as futures and options have a completely different order-to-trade ratio than very liquid stocks such as Vodafone. It's very hard to just set a fixed number for that in the way they've proposed.

Can the language around transparency and consolidated tape be improved in MiFID? Yes, certainly. People have voted now for consolidated tape whereas six months ago they were aggressively against, so we get weaker language now whereas we should have gone for stronger language. And everything around best execution requirements, we would like to see improved to "best price". That's a long shot I know but "best execution" is a pretty ambiguous terminology, there are so many different things that could be included in that.

But certainly the regulations around market access, platforms, co-location, that's all very well written. And the language around interoperability is definitely good, well written and well thought out.

HFTR: Before we conclude, I'd like to get your thoughts on the European Commission's recent decision to block the NYSE Euronext/Deutsche Börse merger. What do you make of that?

MS: We supported the proposed merger under certain conditions and we are disappointed with the outcome, but maybe not for the reasons that people might think. We agree with the exchanges that the consolidation of their markets into one organization can create a lot of efficiencies for market participants such as ourselves. But as we said in the position paper we put out last July, the vertical silo structure creates a lot of barriers to competition in both trading and post-trade services, and we were hoping that this merger would give the European Commission's competition and regulatory authorities an opportunity to work together and address that issue.

Unfortunately that is not the way it worked out. We have clearly missed an opportunity to open up the current monopolies. What's worse, the fact that the two exchanges are now free to go back to doing business as they always have confirms that the way forward is with the current "silos". In effect, what they've done is raise the market price of these particular platforms, because if for example a foreign entity wanted to buy LIFFE, it would be buying into a monopoly confirmed by the Commission.

If you look at Bund/BOBL/Schatz and Euribor futures for example, it would be highly efficient to trade those in the same market space. LIFFE is not competing with Eurex in Bund/BOBL/Schatz futures, they've tried that and they can't do it, likewise Eurex is not competing with Liffe in the Euribor market. It all comes down to that clearing space, which does not support fungibility. And as long as the clearing houses are owned by the exchanges, you will never see a proper link unless mandated by the authorities. So the market is worse off in that respect.

Note that over the last few years we have been able to lower prices for products, lower clearing tariffs, improve risk systems towards real time and enhance technology on all the platforms with clearing competition, such as in the cash equity markets in Europe. Potentially we would have had similar benefits from a newly merged entity with an open clearing solution.

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Another big disadvantage of the situation we're in is that it enhances the OTC world, which is completely against the purpose of MiFID. If the merger had gone ahead, both sets of products could have been cleared in one clearing house or two linked ones, which is much more efficient. The way it stands now, we have to work with two separate clearing houses. Having to create links with both of them and deal with two separate margin regimes creates an incentive to go the OTC route. That's unfortunate because we think the regulators should be looking for every opportunity to make it easier to use the listed markets and bring more OTC products into clearing and into on-screen execution platforms.

To cut a long story short, we think Brussels needs to address this competition issue. The fact that the merger is now off the table should not be the end of the story.

***HFTR:** Given that this seems to be the hand of cards we've been dealt by Brussels, what ideally would you like to see happen now?*

MS: What the parties can and should do is fight this. But the battle needs to be fought in such a way that there's some chance of success, otherwise we'll be two years down the road and no further along. Whether it can be opened up again is a tough question. But the fact that we're now worse off as a result of this decision is a very sad conclusion.

***HFTR:** Finally, on a more positive note, how can European prop traders get involved with EPTA?*

MS: They just need to give us a call or send us an email and we'll definitely get in touch with them and visit them. When we visit, we have an open discussion to understand what their business is like, how their risk controls are, how their back office is set up and so on. Then, if we have a good feeling about them and they have a good feeling about us, we start the application process and we move on.

***HFTR:** And you welcome even very small shops of a few screen traders for example, as well as obviously the bigger firms?*

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MS: Sure. We have the so called “click trading” community represented. Obviously we can’t have banks because the banks have customers. Some banks try to set up independent prop-trading groups, which then have a different structure and a different business model, so they may qualify. But regulation is very high on our agenda, so if people are shy of regulation they won’t qualify.

HFTR: *Thank you Mark*