

From Russia to Riches

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Sergey Zamolotskikh, Russia Trading System Stock Exchange

Because of its energy and commodities boom, Russia is outperforming its peers on the Morgan Stanley Capital International (MSCI) emerging-markets index, a benchmark created to measure equity market performance in growth regions. Profits for Russian companies listed on the Moscow Interbank Currency Exchange (Micex)—one of Russia’s two stock exchanges—are expected to climb by 32 percent in 2011, surpassing the projected average of 24 percent.

In the catacombs of the Kremlin, Russia president Dmitry Medvedev—Gazprom’s former chairman—is using Russia’s BRIC status as a launchpad for his financial reforms, which will see Moscow transformed into an epicenter of financial activity and the strengthening of the ruble’s international position. There are many barriers for international investors who wish to trade on the Russian order books but Medvedev does not intend to be one of them.

A Liquid and Volatile Beast

High-frequency traders naturally gravitate toward markets with the deepest liquidity pools—it is essential for the successful execution of their trading strategies. As a growth market, Russia floats \$2 billion to \$2.5 billion a day in equities—placing it on a par with a major player like Italy—as well as over \$7 billion a day in derivatives and over \$10 billion in the foreign exchange (FX) markets. Because of this burgeoning liquidity, the ex-Soviet behemoth is fast becoming a powerful place to do business.

“These statistics are very interesting to the high-frequency community,” says Tim Bevan, director of global electronic trading services at Otkritie Securities Ltd., the UK-based subsidiary of Russian financial services firm Otkritie Financial Corp., and one of the few firms to offer foreign investors direct market access (DMA) into Russia. “At Otkritie, my job is to get international clients trading in Russia,” Bevan says. “Last year, it was tough—it was very difficult in the aftermath of the financial crisis. ‘Am I interested in electronic access to an esoteric, high-risk market? Not really.’ However, I think the game has changed quite significantly in the last year—as a sales guy, I feel it. I get reverse enquiries almost on a daily basis.”

As well as brimming with liquidity, Russia’s domestic markets are highly volatile. Huge swings in stock prices are part and parcel of being an emerging market. It is also of particular value to high-frequency traders since many of their strategies are specifically designed to take advantage of microstructure inefficiencies.

In terms of securing a competitive edge, the bag is mixed. Many of the global investment banks employ Russian teams to write their algorithms since Russia is a hotbed for programming talent and the execution strategies of the domestic high-frequency traders are as sophisticated as their international counterparts. However, over half of the volume traded on Micex and the Russia Trading System (RTS) Stock Exchange is linked to retail traders—individuals who purchase small amounts of securities for themselves and for whom terms like “low latency” will be meaningless.

This can lead to some very lucrative trading opportunities, according to Adam Sussman, partner and director of research at consultancy Tabb Group. Retail traders differ from their institutional counterparts in that they tend to be less price-sensitive, they hold for longer periods of time, and they don't have access to the trading technologies that institutions would have. “For liquidity-providing high-frequency trading firms, this is an attractive flow to trade against because people trying to get in and out of the market are usually willing to cross the spread in order to put those trades on,” Sussman says.

Of course, a volatile market is also an unpredictable one. High-frequency trading in Russia has the potential to land huge profits, but at the cost of unstable returns. And it is not the only source of risk that international investors have to contend with.

Technological Advances

If President Medvedev wishes to pitch Russia as the Promised Land—and he does—sweeping improvements must be made to Russia's central market infrastructure. Currently, there is no central depository, co-location services are difficult to navigate, and post-trade processes are complex. Also stemming the flow of international high-frequency traders are misconceptions relating to sub-par performance of the exchanges' matching engines.

Starting as it means to go on, the Kremlin facilitated a merger deal between Micex and RTS in February this year. The two exchanges had been bitter rivals for many years but put aside their differences to create “a single powerful infrastructure,” according to a joint announcement by the exchanges. Today, most of the investment community is waiting with bated breath for details of the union—for example, whether RTS will abandon its home-grown infrastructure and move onto Micex's more user-friendly Nasdaq OMX-based platform, and whether the merger will see the creation of a single national depository, as presently each exchange maintains it own.

Of the two national exchanges, Micex holds the monopoly on listed equity trading and operates with an average latency of 10 milliseconds. RTS, meanwhile, runs at a more respectable two to three milliseconds, but its derivatives matching engine is an archaic in-house system that delivers data in 100-millisecond packets, rather than continuously. As yet, neither exchange is a contender in the race for lowest latency but it is a misconception to think that the Russian exchanges do not support high-frequency trading, according to Michael Smith, director of electronic trading at Russian investment bank Renaissance Capital.

“Speed is comparative,” he says. “If everyone drives a car into central London, and they all have to drive through the same traffic light, then it doesn't matter how long that traffic light takes to change because everyone has to go through it. With the assistance of local brokers who can manage the complexities of the market and source liquidity, high-frequency trading in Russia is not that different from the UK.”

Aside from its infrastructure, Russia's settlement and clearing processes raise some eyebrows. Compared to the developed markets, Russian post-trade practices appear to fall on the spectrum somewhere between outmoded and outlandish. At the one extreme, non-digitized ownership

means that some participants still have certificates that need to be signed in order to transfer stock ownership from the buyer or seller, leading to three-week or even four-week settlement cycles. At the other, Micex operates a T+0 settlement cycle, which means that investors are required to pre-fund cash or stock before an order is traded. To make direct market access into Russia more attractive, a number of firms by-pass this issue by running huge capital and equity financing operations; Otkritie Securities, for example, funds 100 percent of activity from trade date to settlement date for many of its clients.

Although Russian settlement cycles are not in sync with international practices, Sergey Zamolotskikh, director of infrastructure projects at RTS, says that reform is not necessary to attract high-frequency traders from abroad. “Settlement cycles do not impact high-frequency traders because they usually distinguish their activity from the settlement itself. The settlement is made after trades are done and because we offer risk management software inside the trading system—I don’t think there is much chance for a trade not to be settled afterward.”

With the developed markets of Western Europe and the US operating T+2 and T+3 cycles, it is tempting to dismiss Russia’s pre-trade risk model as bizarre but had the US adopted a T+0 cycle before the financial crash, the implications for Wall Street might have been very different. High-frequency traders make it their central concern to minimize risk and though T+0 settlement is certainly different from what the West is used to, it is arguably no more or less risky.

Different—but not too different—is the resounding message from firms that operate on the Russian markets on a daily basis. They insist that with the assistance of a local-registered broker, technological barriers in the datacenters, exchanges and clearing and settlement processes can all be successfully circumvented.

Cold War Hangover

With Medvedev at the helm, Russia’s financial market infrastructure and technology is coming gradually into line with international standards, and in the meantime, brokers like Renaissance Capital and Otkritie are bridging the divide. But there is one last deterrent staunching foreign interest in Russia and it is an area where the Kremlin is hindering progress rather than helping.

When talk turns to investment in Russia, the country’s ex-Communist past and recent cases of international deals going sour in the gas and oil sector do little to boost the country’s business credentials. UK oil giant BP and global energy and petrochemicals group Shell have both locked horns with the Russian government over their investments in Russia. Back in 2007, Shell had to abandon its gas field developments on Sakhalin Island after a disagreement over environmental laws, while BP has faced lawsuits, visa disputes and industrial spying claims in its fracas with four Russia billionaires over control of its TNK-BP joint oil venture.

Misplaced

Otkritie’s Bevan accepts that buying and owning assets, or at least having controlling stakes in Russian companies, carries well-documented risks, but says that for high-frequency traders who are considering trading in Russia, these worries are misplaced. “If you’re deploying a high-frequency strategy, your capital commitment is relatively small and there are no issues of control,” he says. “People look at Russian risks and say it’s ‘dodgy,’ but if you stop and analyze what risks you’re taking, they really aren’t significant.”

By virtue of their execution strategies, high-frequency traders are in a better position than others to shield their investments from criminal activities but the ruble is still the currency of the courts. Until the government clamps down on the judiciary system and introduces legislation to protect the investment rights of international companies, high-frequency trading in Russia will be a moot

point. And, for those who can overlook Russia's reputation—or are willing to take the risk—there are still a dozen more barriers to consider. Though they are few and far between, Russian firms with international arms like Otkritie and Renaissance Capital are doing a lot to lower these risks, offering ease-of-access, zero exposure to Russia's regulatory and legal systems, insider knowledge of the RTS and Micex exchanges, and links to the local trading community. But despite rising liquidity and a derivatives market that is currently growing 50 percent year-on-year, it makes little sense to go it alone.

From a fear versus greed perspective, Russia has been a no-go region for a long time, just one of many markets too complicated to decode. But if providers of direct market access to Russian markets are to be believed, all that is about to change.