

FINANCIAL MARKET INFRASTRUCTURE

EXCHANGE CONCEPTS

PART III – Risk & Compliance

A conceptual guide to financial exchange architecture, order books & matching engines.

46	273	10	NO
CHAPTERS	GLOSSARY TERMS	REAL EXCHANGES	MATHS REQUIRED

J. Persson

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Exchange Concepts

An Introduction for Beginners

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Overview

Preface to the Second Edition ix

Preface to the First Edition xi

I Part III: Risk, Compliance, and Post-Trade 1

1 Pre-Trade Risk Controls: Before the Matching Engine 5

2 Risk Controls, Protecting the Market 9

3 Self-Match Prevention, When You Would Trade with Yourself 19

4 Drop Copy, The Shadow Record 21

5 Clearing and Settlement, When the Trade Becomes Real 23

6 Trade Busting and Clearly Erroneous Trades 29

7 Regulatory Surveillance, Exchanges Are Not Passive 33

8 A Cautionary Tale, Knight Capital, August 1, 2012 35

Glossary 39

References 59

Exchanges own technical references 63

Back-Cover Text 67

About the Author 69

Contents

Preface to the Second Edition **ix**

Preface to the First Edition **xi**

I Part III: Risk, Compliance, and Post-Trade **1**

1 Pre-Trade Risk Controls: Before the Matching Engine **5**
1.1 Why a Separate Risk Layer? . . . 5
1.2 Common Pre-Trade Checks . . . 5
1.3 Check Ordering: Fail-Fast by Cost . . . 6
1.4 The Gateway as Risk Layer . . . 7

2 Risk Controls, Protecting the Market **9**
2.1 Circuit Breakers . . . 9
2.2 Should Halt Duration Be Fixed or Proportional to Move Size? . . . 10
2.3 Tiered Thresholds and Durations: How Major Markets Actually Work . . . 10
2.4 The 2020 COVID-19 Circuit Breaker Events . . . 11
2.5 Design Implications for Exchange System Developers . . . 13
2.6 Price Collars (Collar Bands) . . . 13
2.7 Self-Match Prevention (SMP) . . . 16
2.8 Kill Switch . . . 16
2.9 Mass Cancel, Not the Same as a Kill Switch . . . 16

3 Self-Match Prevention, When You Would Trade with Yourself **19**
3.1 The Problem . . . 19
3.2 The SMP Mechanism . . . 19
3.3 How SMP Identifies a Self-Match . . . 19
3.4 Why This Matters for Developers . . . 20

4 Drop Copy, The Shadow Record **21**
4.1 Why Drop Copy Exists . . . 21
4.2 What a Drop Copy Message Contains . . . 21
4.3 Drop Copy vs Market Data . . . 22
4.4 Sequence Numbers and Gap Recovery . . . 22

5 Clearing and Settlement, When the Trade Becomes Real **23**
5.1 What Matching Creates . . . 23
5.2 Clearing: Guaranteeing the Trade . . . 24
5.3 Margin: The Clearing House's Protection . . . 24
5.4 Clearing Members and the Clearing Hierarchy . . . 25
5.5 Delivery versus Payment (DvP) . . . 26
5.6 Settlement: The Actual Transfer . . . 26
5.7 Failed Settlement . . . 27

5.8 Custody and Depositories . . . 27
5.9 VWAP and P&L . . . 27

6 Trade Busting and Clearly Erroneous Trades 29
6.1 Why This Power Has to Exist, and Why It Has to Be Narrow . . . 29
6.2 How a Clearly Erroneous Determination Works . . . 29
6.3 Busting vs Adjusting . . . 30
6.4 How This Connects to Events Already in This Book . . . 30

7 Regulatory Surveillance, Exchanges Are Not Passive 33
7.1 Types of Market Abuse . . . 33
7.2 How Exchanges Detect Abuse . . . 34
7.3 The Audit Trail . . . 34

8 A Cautionary Tale, Knight Capital, August 1, 2012 35
8.1 The Company . . . 35
8.2 The Morning . . . 35
8.3 45 Minutes . . . 35
8.4 The Aftermath . . . 36
8.5 What Went Wrong: A Technical Post-Mortem . . . 36
8.6 The Legacy . . . 37

Glossary 39
A . . . 39
B . . . 40
C . . . 41
D . . . 43
E . . . 44
F . . . 44
G . . . 45
H . . . 46
I . . . 46
K . . . 47
L . . . 48
M . . . 48
N . . . 50
O . . . 50
P . . . 51
Q . . . 52
R . . . 52
S . . . 53
T . . . 55
U . . . 56
V . . . 56
W . . . 56
Z . . . 57

References 59

Exchanges own technical references 63
CME Globex Matching Engine & Implied Logic . . . 63
Cboe US Options Complex Book Architecture . . . 63
Intercontinental Exchange (ICE) Order Books . . . 63
NYSE Pillar (Equity Trading Platform) . . . 64
Further Sources Cited in the Text . . . 64
Notes on Sources Not Cited Inline . . . 65

Back-Cover Text 67

About the Author **69**

Preface to the Second Edition

This book is still for the same person: the developer who gets dropped into an exchange codebase full of words like “NBBO”, “LULD”, “implied in/out”, “ATC”, “SIP”, “MMP”, and quietly wonders whether they have accidentally joined a cult. You have not. You have joined a domain with very old vocabulary, very modern latency budgets, and very expensive failure modes.

The first edition focused on giving the reader a map. This second edition keeps the same promise, almost no code-first deep dives, no equations for their own sake, just concepts that make the system legible, but the map is now wider, denser, and more practical. Compared with the first edition, this edition adds well over a thousand lines of new material and rewrites key chapters that were a bit too brief in the first pass where obviously my aspiration to keep it short sometimes conflicted with the need for completeness and understandability. Some pseudo-code has in addition been added where it helps clarify the mechanics, but the focus is still on concepts, not implementation. The goal is still to give you a mental model that lets you reason about the system, not just translate jargon.

The largest expansion is in the implied-orders material, which has been rebuilt from a short overview into two full chapters placed at the end of Part II, once the order book and the matching engine are familiar. The first is a complete walkthrough: the spread sign convention, a vector model from which every implied price formula follows, quantity, depth and priority rules, tick alignment, market-data publication, a first-generation algorithm, engineering invariants, and self-check exercises with worked solutions. The second follows chains of implied orders across many contract months and shows why every venue must limit how far implication is allowed to reach. The order-book chapter has also been expanded from concept to implementation shape: cache behavior, memory layout, single-threaded matching partitions, pool allocation, and step-by-step insert/cancel/sweep mechanics, including determinism concerns.

Several missing bridge topics are also now included explicitly. Part I this time around closes with listing (including the part black-magic art of IPO valuation) and delisting mechanics (initial and continued standards, cure periods, reverse splits, voluntary delisting, direct listings, and SPAC pathways). Part II adds round-lot vs odd-lot treatment and a dedicated tick-size chapter (Rule 612, historical fraction pricing, Tick Size Pilot, and midpoint rounding). The auction material has been upgraded with auction-only order types, opening/closing cross mechanics, and manipulation-at-the-close context.

Beyond core matching, this edition also adds the operational and structural topics developers eventually run into: benchmark integrity (LIBOR and FX fix case studies), trade busting and clearly erroneous handling, conformance testing and onboarding drift, market-data economics (SIP vs proprietary feeds, locked/crossed markets), fixed-income microstructure, crypto venue differences, and options expiry mechanics (exercise, assignment, settlement type, and pin risk).

So yes, the document is longer now. That is deliberate. The first edition tried to keep every section short; this one tries to keep every section useful when things get messy in production. If the first edition was the “day one” guide, this one aims to be the “month six” guide, the point where you are no longer asking what a term means, but why the system was designed that way and what breaks if it is wrong.

As before, this is an introduction, not a rulebook. Exchange rulebooks and venue technical specifications remain the final authority. But if this second edition helps you move from terminology to reasoning faster, it has done its job. The reference section includes the publicly available reference material many details in this books draws from to be as exact as possible.

Reasonable efforts have been made to ensure accuracy, but, it would be foolish of me to believe that I during some late night/early morning while editing this book didn't swap some bid/ask columns or simply forgot a whole section I had in my notes or my mind.

Enjoy the pleasure of finding things out and the triumph of being sure that the author was proveable wrong! So, any typos, missing signs, bad explanations/grammar or faults otherwise, are mine and mine alone. I have no-one to blame!

If you find any mistakes or have other suggestions, please let me know at *johan162@gmail.com*. I genuinely appreciate it.

Johan Persson, Second Edition, Autumn 2026, Järnboås Socken

Preface to the First Edition

This is a book for anyone who finds themselves having been asked to work on a financial exchange system, and yet, has no financial background. Scary. The codebase is full of words like "bid," "ask," "FOK," "the book," "OCO," "circuit breaker," "drop copy," and "kill switch," and many more. These are not arbitrary names; each one represents a concept that evolved over decades of real-world market operation, regulation, and hard-won lessons about what can go wrong when large amounts of money change hands at high speed. You just happened to be "unlucky" enough to start when all these terms have already been defined. Had you instead started 50-ish years ago the terms did not yet exist and you would have seen them come to life organically.

My goal with this book is simple: give you the conceptual vocabulary so that when someone says "GW01 submitted a GTC iceberg order that triggered a circuit breaker halt," you nod instead of panic. No code. No math. Just the map of the territory your code inhabits.

I have tried to keep things brief: each concept gets only as much space as it needs to be useful, and not a page more. Where I have necessarily oversimplified, you will find pointers at the end to the proper academic treatments (hundreds of pages of the hard stuff) for those rare evenings when you feel brave (or masochistic) enough to dive deeper. I make that promise with a clear conscience, because I spent rather too many evenings, and far too many weekends, working through the classic finance texts listed in the references, which served as the primary sources for this little book. If I am honest, this booklet is really nothing more than my own "lecture notes" from all that reading, tidied up and handed to you so you can skip the long way round. In the reference section you can find micro-reviews of all the books I used and taken inspiration from. You can also discover my own personal favourite!

This is an introduction, not a specification. Real exchanges are far more complex, and their official rulebooks are the final word. Think of this as the document I wish someone had handed me on day one I started to work in this world. I hope it helps you get up to speed faster than I did.

Reasonable efforts have been made to ensure accuracy, but as usual any remaining errors are entirely my fault. If you find mistakes or have suggestions, please let me know at *johan162@gmail.com* I genuinely appreciate it!

Johan Persson, First Edition, Winter 2025/2026, Järnboås Socken

PART I

Part III: Risk, Compliance, and Post-Trade

The safeguards that protect markets and participants, before, during, and after each trade, and the regulatory obligations that underpin them.

Historic Notes

In the last week of February 1995, Peter Baring, chairman of Barings Bank, had to tell the Bank of England that his bank was in trouble. Barings, founded in 1762, Britain's oldest merchant bank and one of the most respected financial institutions in the world, had a problem. One of its traders in Singapore, a 28-year-old named **Nick Leeson**, had accumulated positions in Nikkei 225 futures that nobody at headquarters knew about. The positions totalled approximately $7 billion in notional exposure. Leeson had hidden the losses in an error account numbered 88888, exploiting gaps in the firm's controls and the geographic distance between Singapore and London. When the 1995 Kobe earthquake sent Japanese equity markets sharply lower, Leeson's positions collapsed. Barings' total losses were £827 million, more than twice the bank's available capital. On 26 February 1995 the bank was placed in administration, and it was sold to the Dutch bank ING for £1. The UK's oldest merchant bank had ceased to exist as an independent firm [Bank of England Board of Banking Supervision, *Report of the Inquiry into the Circumstances of the Collapse of Barings*, July 1995].

Barings had pre-trade risk controls. They were simply not checking position limits at the firm level, not monitoring the error account's exposure, and not asking why a single trader in Singapore was generating such unusual patterns of activity.

Every section of Part III is, in some sense, the answer to the question: "What would have stopped Nick Leeson?" Pre-trade position limits would have flagged his accumulation. A firm-level kill switch, properly monitored, could have halted his trading. A drop copy feed to an independent risk team would have revealed the hidden positions. Regulatory surveillance would have detected the anomalous patterns. And the Knight Capital story at the end of this Part shows that a firm can have many of these controls and still fail, if nobody is able to stop a runaway system for 45 minutes.

Part Summary:

Focus on market safety and accountability: the controls that prevent bad orders, the mechanisms that stabilize volatility, and the post-trade processes that make executed trades legally and financially final.

Learning Objectives:

- Explain why pre-trade controls are separated from matching in production architectures.
- Understand circuit breakers, collars, SMP, and kill switches as layered protections.
- Distinguish routine order-management actions from emergency risk interventions.
- Follow the trade path beyond execution into clearing, settlement, and surveillance.

Content:

- Pre-Trade Risk Controls: Before the Matching Engine
- Risk Controls, Protecting the Market
- Self-Match Prevention, When You Would Trade with Yourself
- Drop Copy, The Shadow Record
- Clearing and Settlement, When the Trade Becomes Real
- Trade Busting and Clearly Erroneous Trades
- Regulatory Surveillance, Exchanges Are Not Passive
- A Cautionary Tale, Knight Capital, August 1, 2012

CHAPTER 1

Pre-Trade Risk Controls: Before the Matching Engine

The matching engine is the heart of the exchange, but many orders never reach it. A layer of **pre-trade risk controls** sits between the participant and the matching engine, rejecting orders that violate size, price, or credit constraints before any matching logic runs. This separation matters architecturally: the matching engine is optimised purely for speed; risk checking is separated so that it can be comprehensive without slowing the core matching path.

1.1 Why a Separate Risk Layer?

A professional trading firm may submit thousands of orders per second. Even a brief software malfunction, a misconfigured algorithm, a bad data feed, a network glitch causing order duplication, can flood the exchange with harmful orders. If each of these reached the matching engine, the damage could propagate to other participants through filled trades that cannot easily be reversed. Pre-trade risk controls are the exchange's first line of defence.

1.2 Common Pre-Trade Checks

Maximum order quantity. An order for 1 billion shares is almost certainly an error. Every exchange imposes an upper limit on the quantity of any single order. The limit may be absolute (no order may exceed X shares) or relative (no order may exceed Y% of the recent average daily volume).

Maximum notional value. Complementary to quantity limits: the total value of an order (quantity $\times$ price) must not exceed a threshold. A limit buy for 1,000 shares at \$150.00 has a notional value of \$150,000. If the threshold is \$10 million, the order passes. If the participant submits 1,000 shares at \$15,000 due to a decimal error, the notional is \$15 million, rejected.

Fat-finger price filter. Orders whose submitted price is far from the current market price are rejected before reaching the matching engine. This catches typographical errors (an extra zero, a misplaced decimal point) before they touch the book. The fat-finger filter is calibrated per instrument based on its typical price range and volatility.

Position limits and credit limits. These two controls are frequently grouped together but measure different things and require different data to evaluate.

Position limits cap the number of units a participant may hold in a given instrument, long or short. A position limit of 500,000 shares means a participant cannot hold more than 500,000 shares long or be more than 500,000 shares short at any time. Checking a position limit requires knowing the participant's current settled and unsettled position, data fed from the clearing system into the gateway as a continuously updated parameter. They are designed to prevent any single participant from accumulating a position large enough to create settlement or market concentration risk.

Credit limits (also called notional or exposure limits) cap the total financial obligation outstanding at any

moment: the mark-to-market value of current positions plus the notional value of all open orders not yet filled. A credit limit of $10 million means the sum of position value plus unfilled order commitments cannot exceed $10 million. Credit limits are harder to check in real time than position limits because they require tracking the full "open order book", every outstanding order submission and cancellation, as well as settled positions. For example: a participant already long 50,000 shares, with a position limit of 75,000, submits a buy order for 50,000 more; the order would take the position to 100,000, so it is rejected as a position limit breach. A separate check might reject an order because the notional value of all outstanding orders already exceeds the credit threshold, even if the eventual position itself would be within limits.

Rate limiting / throttling. Each participant connection (gateway) is permitted to submit at most N orders per second. If submissions arrive faster than this rate, excess orders are queued or rejected. This protects the exchange from denial-of-service conditions, whether deliberate or accidental.

Short sale flagging. In the United States, Regulation SHO (in force since 2005) requires every sell order to be marked "long", "short", or "short exempt", and a short sale to be backed by a **locate** confirming the shares can be borrowed. The division of labour matters for developers. The *broker-dealer* that accepts the client's order is responsible for the locate, and its own pre-trade risk layer checks it; the exchange cannot know who owns what. What the exchange gateway can and must enforce is that the marking field is present and valid, because it drives exchange-side behaviour (for example, the short-sale price test of Rule 201, which restricts short sales in a stock that has already fallen 10% in a day) and is recorded in the audit trail. As described in the *Short Selling* section of Part I, the locate process itself happens in prime brokerage infrastructure outside the exchange.

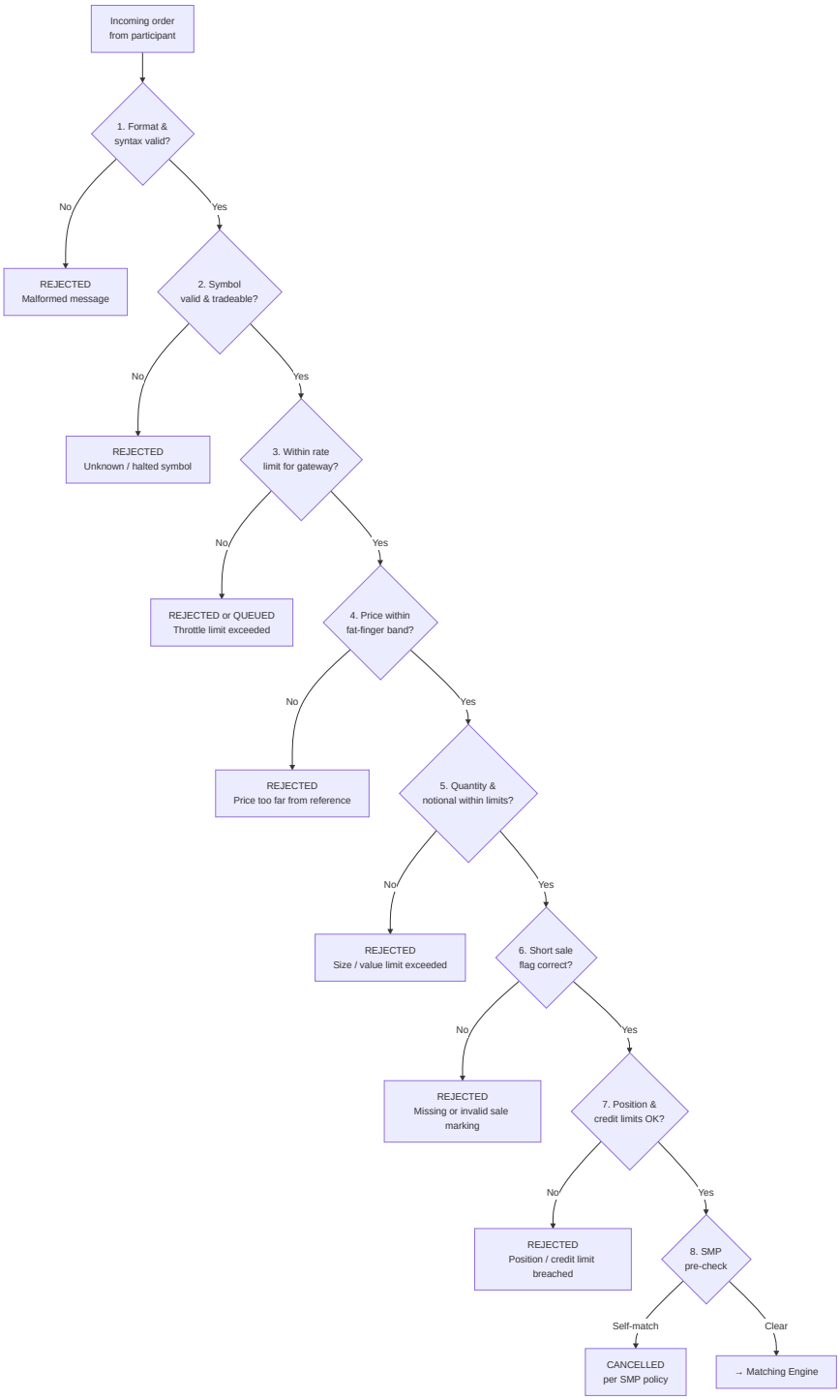
Self-match prevention (SMP). Detects when an incoming order would match against a resting order from the same participant, a "wash trade." Described fully in the *Self-Match Prevention* section of this Part.

1.3 Check Ordering: Fail-Fast by Cost

The sequence in which pre-trade checks run is not arbitrary. Checks requiring external state lookups are more expensive than checks that can be performed on the order message alone. The standard pattern is to fail-fast with the cheapest checks first:

1. **Format and syntax**, Is the message well-formed? Are required fields present and correctly typed? Zero external lookups. Cheapest possible rejection.
2. **Symbol validity**, Is the symbol known, active, and in a session state that accepts orders? Requires only a reference data table lookup.
3. **Rate limiting**, Is this gateway within its message rate allowance? In-memory counter per gateway, no external state.
4. **Fat-finger price check**, Is the submitted price within a configured percentage of the reference price? Requires only a cached reference price per symbol.
5. **Quantity and notional limits**, Does the order exceed size or value thresholds? Requires only the order fields and configured thresholds.
6. **Short sale marking check**, If the order is a sell, is it marked long, short, or short exempt, and does the marking pass any active short-sale restriction?
7. **Position and credit limits**, Would this order breach the participant's position or credit limits? Requires current position data from the clearing system, the most expensive check.
8. **SMP pre-check**, Does an obvious self-match with a resting order exist?

Failing at step 1 takes nanoseconds. Failing at step 7 takes longer because it requires consulting external state. Running all checks in parallel wastes resources on orders that would be rejected at step 1; running them in this sequence minimises latency for both accepted and rejected orders.



1.4 The Gateway as Risk Layer

In most production architectures, the gateway performs these checks. The gateway is the first system to touch an incoming order; it can reject it immediately without the order ever reaching the matching engine's single-threaded queue. This keeps the matching engine clean and fast.

The consequence for software design: the gateway and the matching engine have different codebases, different deployment configurations, and different update cadences. The gateway can be scaled horizontally (multiple gateway processes); the matching engine is typically single-threaded per symbol.

> **Key idea:** The matching engine is optimised for speed, not safety. Safety is enforced before the order arrives. Developers working on gateway code must treat pre-trade checks as first-class functionality, not as an afterthought.

CHAPTER 2

Risk Controls, Protecting the Market

An exchange has a duty not just to its participants but to market stability as a whole. The risk controls described in this section exist because markets can go very wrong, very fast.

2.1 Circuit Breakers

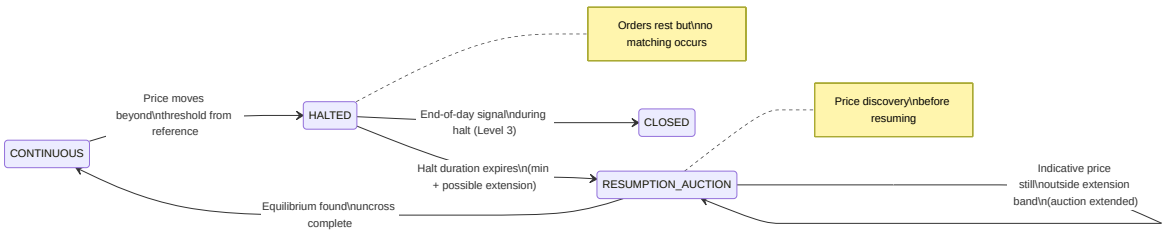
A **circuit breaker** (also called a **trading curb** in some regulatory contexts) is a mechanism that automatically halts trading when prices move too fast. The name comes from electrical circuit breakers, they "trip" to prevent damage when current (activity) becomes excessive.

Why they exist: In modern electronic markets, automated trading algorithms can drive prices far from fundamental value in seconds. The **2010 Flash Crash** saw the Dow Jones Industrial Average fall nearly 1,000 points in minutes before recovering [7]. Circuit breakers prevent such cascades from becoming permanent damage by imposing a mandatory pause during which participants can assess the situation, cancel erroneous orders, re-price their quotes, and allow the market to find equilibrium. A halt that lasts five minutes can prevent a price dislocation that might otherwise take hours or days to unwind.

The origin of circuit breakers is the **Black Monday crash of 19 October 1987**, when US markets fell 22.6% in a single day. The Presidential Task Force on Market Mechanisms (the Brady Commission) recommended coordinated market-wide pause mechanisms in its January 1988 report, directly leading to the first exchange circuit breakers being implemented. The full history is in the *Black Monday and the Origin of Circuit Breakers* section of Part I.

The basic mechanism: After each trade, the exchange calculates how much the price has moved relative to a reference price (typically the most recent auction price, or the price at the start of a defined time window). If the movement exceeds a configured threshold in either direction, trading in that symbol is halted. During the halt, new orders can still be submitted and will rest in the book, but no matching occurs. When the halt ends, trading resumes through a **resumption auction** rather than instantly returning to continuous matching, this ensures that the first post-halt price is determined by the broadest available supply and demand, not by a single resting order that happens to be at the top of a thin book.

The circuit breaker introduces its own state machine within the trading session:



Note that this is a sub-machine nested within the full trading session state machine (which is described in Part II). A halt can occur multiple times during a single session; each time the circuit breaker trips

in CONTINUOUS, the session cycles through HALTED → RESUMPTION_AUCTION → CONTINUOUS before continuing.

2.2 Should Halt Duration Be Fixed or Proportional to Move Size?

This is a genuine design question, and the answer, confirmed by how major markets actually operate, is that both the trigger thresholds *and* the halt durations should be graduated by severity. The reasoning is straightforward: the purpose of a halt is to allow participants enough time to respond. A 0.5% move may reflect a momentary liquidity gap that resolves in two minutes. A 15% move may reflect genuine macroeconomic news that requires participants to read announcements, consult risk managers, recalculate valuations, and obtain fresh margin collateral, a process that cannot be completed in two minutes no matter how urgently it proceeds.

There is also a clearing-house dimension: a large move triggers margin calls at the CCP. The clearing house must calculate the calls, and participants must fund them. A halt that ends before margin can be collected leaves the clearing house exposed to exactly the counterparty risk that margining is designed to eliminate. Longer halts on larger moves give the clearing infrastructure time to operate correctly.

The counterargument: predictability has value. The main argument for a fixed halt duration is that participants value certainty. A fixed 5-minute halt lets every participant set a timer, prepare their re-entry orders, and be ready the instant continuous trading resumes. A variable halt ("somewhere between 5 and 30 minutes depending on severity") creates uncertainty that can itself generate anxiety and cautious behaviour. Some exchanges deliberately publish a fixed duration for this reason, the predictability is considered worth more than the additional precision of proportional calibration.

The practical resolution used by many exchanges is a **minimum halt with conditional extension**: the halt lasts at least the minimum duration, but the resumption auction can be extended in fixed increments (say, 2 minutes at a time) if the indicative uncross price is still far from the reference price when the auction is about to close. This bounds the uncertainty (participants know the halt is at least N minutes) while preventing a forced uncross at a price nobody believes in.

2.3 Tiered Thresholds and Durations: How Major Markets Actually Work

US market-wide circuit breakers (S&P 500 index)

The US operates three explicitly tiered halt levels, where the severity of the market drop determines both whether a halt occurs and how long it lasts:

Level	S&P 500 intraday decline	Halt duration	Notes
Level 1	7%	15 minutes	Not triggered in last 35 minutes of session
Level 2	13%	15 minutes	Not triggered in last 35 minutes of session
Level 3	20%	Remainder of trading day	Triggered at any time; session ends

Level 3 is effectively infinite for that day: a 20% intraday crash ends all US equity trading. The logic is that such a move cannot be a technical error, it is a market-wide catastrophe requiring the financial system to assess damage, value positions, and meet obligations overnight before resuming trading.

These market-wide halts are rare; Level 1 was triggered four times in March 2020 during the COVID-19 crash. Level 3 has never been triggered under the current rules.

US single-stock circuit breakers (LULD, Limit Up-Limit Down)

For individual stocks, the US LULD system takes a complementary approach: rather than varying the halt duration by severity, it varies the *trigger band* by instrument type, acknowledging that normal volatility differs across stocks.

Tier	Instruments	Band during regular hours	Band in early/late sessions
Tier 1	S&P 500, Russell 1000, selected ETFs (priced above $3)	±5%	±10%
Tier 2	Other NMS stocks (priced above $3)	±10%	±20%
Leveraged ETPs	Band multiplied by the product's leverage factor	Wider, per the plan's rules	Wider still

(Stocks priced at $3 or below have wider bands. The doubled "early/late" bands apply before 9:45am and after 3:35pm.) The bands are recalculated continuously from a reference price, the average trade price over the preceding five minutes. Trades outside the band are simply not allowed. If the best bid or offer sits exactly at the band (a **limit state**) and does not recover within 15 seconds, a 5-minute trading pause is triggered. The halt duration is fixed at 5 minutes regardless of how far the price moved, but the threshold that triggers the halt reflects the instrument's normal volatility characteristics.

2.4 The 2020 COVID-19 Circuit Breaker Events

The most recent real-world test of the US market-wide circuit breaker system was the four Level 1 halts triggered in March 2020. These remain the only times the modern percentage-based system has halted all US equity trading, and they confirmed both that the mechanism worked as designed and that it had not been calibrated for the specific dynamics of a pandemic-driven crash.

Date	Trigger time (ET)	Prior S&P 500 close	7% trigger level (93% of prior close)	Context
March 9, 2020	9:34 AM	2,972.37	2,764.30	Saudi–Russia oil price war combined with accelerating COVID-19 spread
March 12, 2020	9:35 AM	2,741.38	2,549.48	WHO had declared COVID-19 a pandemic the day before; US announced European travel restrictions
March 16, 2020	9:30 AM	2,711.02	2,521.25	Triggered at the opening despite an emergency Fed rate cut the previous evening
March 18, 2020	12:56 PM	2,529.19	2,352.15	Intraday halt as liquidity withdrew mid-session

Each halt lasted the mandatory 15 minutes. Trading resumed through a brief reopening auction each time. The halts functioned as the Brady Commission intended: providing a window for participants to cancel

erroneous orders, re-submit with updated prices, and allow the resumption auction to establish a coordinated reopening rather than a scramble into a thin book.

Several operational characteristics of these events are worth noting for exchange system developers:

Level 2 was not triggered, even though the Dow Jones Industrial Average fell about 13% on March 16. Two details explain why. First, the market-wide circuit breakers are driven by the **S&P 500**, not the Dow, and the S&P 500 closed down about 12%, never reaching its 13% threshold. Second, every level is measured from the *previous day's close*: the reference does not reset after a Level 1 halt. (Also, a Level 1 or Level 2 halt can occur only once per day; after one Level 1 halt, only a 13% decline can halt trading again that day.) For a developer this is a reminder to implement exactly what the rule says: which index, which reference price, and which percentage.

Market-wide circuit breakers do not apply before 9:30am. The March 16 halt triggered at the exact opening bell because the overnight futures market had already been limit-down on CME (CME imposes its own ±5% limit on equity futures outside regular hours). The circuit breaker mechanism described in this section governs only the regular session. Pre-market and after-hours risk management is handled separately at the futures exchange level.

Single-stock LULD pauses ran in parallel. Independently of the four market-wide halts, individual stock LULD pauses were triggered thousands of times throughout March 2020 as individual securities moved outside their instrument-level bands. Market-wide and single-stock circuit breakers are entirely separate systems with different triggers and separate enforcement.

Eurex and European venues: volatility interruptions

Eurex uses **volatility interruptions** for individual futures and options products. When the price moves beyond a configured range from the reference price, continuous trading is interrupted and a brief auction is called. The duration is not rigidly fixed: the auction continues until equilibrium is found, with a minimum duration and the ability to extend if the indicative price remains far from the reference. This auction-based resumption (rather than a timed pause followed by immediate continuous trading) means the halt naturally lasts as long as price discovery requires.

A cautionary counter-example: China's four-day circuit breaker, January 2016

Every real-world example in this section so far shows circuit breakers working roughly as intended. It is worth pausing on one prominent case where a circuit breaker system made things measurably worse, because it clarifies exactly what careful calibration is protecting against.

On 1 January 2016, China's CSRC introduced a market-wide circuit-breaker system for the CSI 300 index, modelled in broad outline on the US approach described above but with its own thresholds: a 5% decline triggered a 15-minute market-wide halt, and a 7% decline closed the market for the remainder of the day. The system was live for only four trading days. On 4 January 2016, the market fell 5%, triggering the 15-minute halt; trading resumed only to fall through the 7% threshold within minutes, closing the market for the day. On 7 January, the same sequence repeated even faster, the market closed for the day within roughly thirty minutes of the open. The CSRC suspended the entire mechanism after this second event, just four days after introducing it.

The design flaw was the narrow **gap between the two thresholds** (5% and 7%, only two percentage points apart) combined with a **single index-wide trigger for a market with unusually large retail participation**: once the 5% halt was reached, rational participants anticipating that a further, small additional decline would close the market entirely for the day had a strong incentive to sell *immediately* upon resumption, to exit before the second, harsher halt made their positions unsellable until the next session. The circuit breaker, intended to give participants time to calm down and reassess, instead concentrated urgent selling into the narrow reopening window, the opposite of its purpose. This is a direct, real-world confirmation of the design principle raised earlier in this section, that threshold spacing and halt duration must be calibrated together, and it is the reason the wider gaps in the US system (7%, 13%, 20%, each roughly double the previous) and Japan's continuous-limit approach (below) are not arbitrary choices but responses to exactly this kind of failure mode. [China Securities Regulatory Commission public statements, January 2016; contemporary reporting including *Reuters*, "China scraps circuit breaker after just four days," 7 January 2016.]

Japan: daily price limits

JPX (Japan Exchange Group) uses a different paradigm: instead of a halt, the exchange imposes **daily price limits** that prevent the price from moving more than a set percentage from the previous close. If the price hits the limit (up or down), trading can continue at that price but cannot move beyond it. This is a continuous constraint rather than a discrete halt: the market remains open but price movement is bounded. When a stock stays pinned at its limit without trading for consecutive days, the exchange widens the limit. This approach prioritises continuity over interruption.

2.5 Design Implications for Exchange System Developers

A well-designed circuit breaker subsystem is not a single boolean "halt or not halt." It is a configurable, multi-tier system with the following parameters per instrument (or instrument group):

- **Reference price source:** Last auction price? Rolling 5-minute reference? Opening price?
- **Measurement window:** How far back does the comparison look? (Some use the last trade; others use the last 5 minutes of trades to avoid single-trade noise.)
- **Trigger thresholds:** One threshold or multiple tiers (7%, 13%, 20%)?
- **Halt duration per tier:** Fixed time, minimum-plus-extension, or auction-until-equilibrium?
- **Extension condition:** If halt duration is extendable, what is the condition for extension? (Indicative price outside a band? Insufficient volume in the resumption auction?)
- **Maximum halt duration:** Is there a ceiling beyond which the halt automatically transitions to session-end?
- **Day-of-session rules:** Some halts (like US Level 1/2) do not trigger in the last 35 minutes of the session to avoid trapping participants with no time to exit.
- **Resumption mechanism:** Immediate continuous trading or mandatory resumption auction?

All of these should be stored in reference data and readable at runtime without a code deployment. A circuit breaker whose parameters require a software release to adjust is a liability, market conditions and regulatory requirements change, and the ability to tune the parameters independently of the engine is essential operational flexibility.

> **Key idea:** Circuit breakers are not binary on/off switches. They are tiered, configurable risk controls where both the trigger threshold and the halt duration should scale proportionally with the severity of the price movement. A small disruption needs a short pause; a large crash may end the session entirely. The US market-wide circuit breaker system (7%/15min, 13%/15min, 20%/rest-of-day) is the canonical real-world example of this principle in practice.

2.6 Price Collars (Collar Bands)

Price collars are price filters that reject individual orders whose submitted price is too far from a reference price.

There are typically two bands:

Static collar (fat-finger filter): Compares the submitted price to the last official close price. If the submitted price is more than X% away from the close, the order is rejected. This catches "fat finger" errors, trader mistypos that accidentally add or remove a zero. A sell order at $15.00 when the stock is trading at $150.00 is almost certainly a typo and should never reach the book.

The term **fat finger** is industry slang for typing errors, accidentally pressing the wrong key. A famous fat-finger incident occurred in 2005 when a Mizuho Securities trader accidentally sold 610,000 shares of a Japanese company at 1 yen each instead of 1 share at 610,000 yen. The resulting chaos cost the firm hundreds of millions of dollars and prompted stricter controls globally. [16]

Dynamic collar (reference price filter): Compares the submitted price to the most recent traded price. If the submitted price is more than Y% away from the last trade, the order is rejected. This prevents a participant from slowly walking the price away from fair value through a series of trades, each slightly outside the previous range.

The two collars serve different purposes: - The static collar protects against outright mistakes (orders many times the current price). - The dynamic collar protects against gradual manipulation or runaway algorithms.

Automated Corridor Expansion (ACE)

A corridor is a promise: *this market will not trade outside this band.* On an ordinary day that promise costs nothing. On an extraordinary day it becomes a trap. Suppose a company announces overnight that it has been acquired at a 25% premium. The "right" price really is 25% higher, and a collar of ±10% around yesterday's close now blocks every trade that reflects reality. The venue is left with two bad choices: keep the collar and let nothing trade (the market is effectively closed exactly when participants most need it), or drop the collar and let the first few orders print at whatever price they happen to carry (the collar was there precisely to stop that).

Automated Corridor Expansion (ACE) is the family of rules that avoids both. Instead of forcing an immediate yes-or-no decision, the venue *keeps collecting orders* for the affected instrument, repeatedly asks "at what price would these orders trade?", and, if the answer is still outside the band, *widens the band by a predefined step* and asks again. The instrument reopens as soon as the price the orders imply fits inside the (now wider) band. Only that one instrument waits; the rest of the market keeps trading normally.

A note on the name: "ACE" is this book's label for the pattern, not a standardised industry term. Real venues each have their own names and parameters (the examples below give several), and the reference exchange that accompanies this book implements it under the name *Automated Corridor Expansion*, where "corridor" simply means the collar used for a reopening.

As an example, Deutsche Boerse adopted the ACE (Automated Corridor Expansion) Model for ETFs in 2021, accounting for the specific nature of ETPs and their intrinsic higher volatility.

The mechanism is publically described in Market Model for the Trading Venue Deutsche Börse Xetra

How it works, step by step. Every ACE design has the same moving parts:

1. **A trigger.** The instrument's price has hit its collar or circuit-breaker threshold, and continuous matching stops *for that instrument.* It enters a **call phase**: orders are accepted and rest in the book, but nothing matches (the same mechanics as the opening auction in Part II).
2. **A latched reference price.** The collar is centred on a reference price captured at the moment of the trigger. It is *latched*, frozen for the duration, so that nothing traded elsewhere can shift the target while participants are responding to it.
3. **A dry-run uncross.** At the end of the call phase, the engine computes the auction equilibrium price (the price that would maximise executable volume) *without executing anything.* This is the **indicative price**.
4. **The decision.** If the indicative price lies inside the collar, the instrument reopens with a normal auction uncross at that price. If it lies outside, the instrument does *not* reopen: the collar is widened by the next step of a published **expansion ladder**, and a new call phase starts. All resting orders stay in the book throughout.
5. **Termination.** Because each step makes the collar wider, it eventually contains any finite price, so the instrument always reopens eventually. Designs differ on what else may end the process: the end of the trading day, a maximum number of steps, or a human decision.

A worked example. Take a stock with a reference price of **$100.00**, an initial collar of ±10%, a first widening of 10 percentage points, and later widenings of 20 points each, with 5-minute call phases. A burst of buying after big news produces an indicative price of **$122.00**, which stays put.

Time	Collar	Indicative price	Inside?	Outcome
Trigger (0 min)	$90.00 – $110.00 (±10%)	–	–	Call phase 1 begins
End of call 1 (5 min)	$90.00 – $110.00 (±10%)	$122.00	No	Widen by 10 points, call phase 2
End of call 2 (10 min)	$80.00 – $120.00 (±20%)	$122.00	No	Widen by 20 points, call phase 3
End of call 3 (15 min)	$60.00 – $140.00 (±40%)	$122.00	**Yes**	Reopen: uncross at $122.00

These are the numbers from the SEC's own illustration of Nasdaq's rule, described below. Notice what the extra ten minutes buy. Every participant can see that the stock is heading for a 22% move and has time to react: sellers who think $122 is too high can enter orders, and if enough of them do, the indicative price falls back and the stock reopens earlier, inside a narrower collar. The expansion does not decide the price; it slows the process down just enough for the market to decide it with everybody watching.

Note also that the widening is **additive on the reference price**: each step adds a percentage of the *original* $100 reference, so the band grows by a fixed number of dollars per step rather than compounding. That keeps the ladder predictable, which is the whole point of publishing it.

Design choices that differ between venues.

- **Symmetric or directional.** Nasdaq widens both sides of the collar. NYSE's reopening after a Limit Up-Limit Down pause widens only the side facing the order imbalance: the opposite side stays where it was, since there is no pressure in that direction to accommodate.
- **Step size and interval.** How far to widen and how long each call phase lasts trade speed against safety: big, fast steps reopen quickly but offer less protection; small, slow steps protect but can keep an instrument dark for a long time.
- **Predictable or random end.** If everyone knows the exact moment a call phase ends, the last order to arrive has seen everyone else's and cannot be answered. Many venues therefore end call phases at a random moment after a minimum duration, as Deutsche Börse's Xetra does for its auctions.
- **Automatic or manual last resort.** Some designs never stop widening; others hand the final decision to people. On Xetra, if the potential price lies outside an even wider "extended" price range, the call phase continues until market supervision ends the volatility interruption manually.

Real-world examples.

- **NYSE (and the other US primary listing exchanges), 2017.** Since 20 November 2017, when a stock cannot reopen from a Limit Up-Limit Down trading pause inside its auction collar (initially 5% below the auction reference price on the lower side, with the Limit Up-Limit Down upper price band as the upper side), the pause is extended by five minutes and the collar is widened by a further 5% of the reference price, in the direction of the imbalance only, and this repeats until the stock can reopen. With a reference price of $90, each step moves the collar by $4.50 [NYSE, *Enhancement to Reopening Process after LULD Trading Pauses*, 2017].
- **Nasdaq, 2025.** For halts other than LULD pauses (news-pending halts, for example), the SEC approved in February 2025 "Halt Cross" price protections: a reopening must fall within 10% of a reference price; if it cannot, the collar widens by 10% after the first five minutes and by 20% after each subsequent five minutes, exactly as in the worked example above [SEC Release No. 34-102336, 10 February 2025].
- **Xetra (Deutsche Börse).** A volatility interruption extends the auction call phase when the potential price lies outside the static or dynamic price range; the call phase then ends at a random moment after a minimum duration, and an "extended" volatility interruption is ended manually [Deutsche Börse, *Protective Mechanisms in Auctions*].
- **CME agricultural futures.** A simpler, slower cousin: after a contract settles at its daily price limit, the next day's limit is expanded, for example from $0.30 to $0.45 per bushel for corn, so that the market is not locked at the limit day after day [CME Group, *Price Limits*]. No halt is involved at all; the band simply widens for the next session.

What this means for developers. ACE turns the collar from a single number into a small state machine: *normal → call phase → (dry-run, widen, call phase)* → reopen.* The engine needs a dry-run mode of its auction algorithm that computes the indicative price without executing, a latched reference price per instrument, and a ladder read from reference data rather than hardcoded. Every widening must be published to market data and written to the audit trail, because participants need to see the new collar to respond to it and regulators will ask why the instrument reopened when it did. If the end of each call phase is randomised, the random number generator must be treated as an input to the deterministic engine (seeded and recorded), or the replay guarantees of the *Determinism, Replay, and Persistence* chapter are lost. Finally, the ladder needs a defined interaction with the end of the trading day: an instrument still in a call phase at the close must resolve somehow, whether by a forced closing uncross, by rolling its orders into the next session, or by an operator's decision.

Key idea: A fixed collar either blocks a genuine repricing or gives way to an absurd one. Au-

tomated Collar Expansion does neither: it pauses only the affected instrument, keeps collecting orders, and widens the collar in published, predictable steps until the price the orders imply fits, so that large moves are allowed to happen, but slowly enough for the whole market to take part in setting the price.

2.7 Self-Match Prevention (SMP)

A participant should not be able to trade with themselves. If you have a resting sell order at $150.35 and you submit a buy order at $150.40, those orders would match, but both sides belong to you. No real change of ownership has occurred; you have simply generated artificial trading volume. This is called **wash trading** and is illegal under most exchange regulations.

Self-Match Prevention (SMP) detects when an incoming order would match against a resting order from the same participant (identified by gateway ID) and applies a policy:

- **Cancel Aggressor:** Cancel the incoming order. Your resting order remains. This is the most common default.
- **Cancel Resting:** Cancel the resting order and continue looking for a counterparty. Used when the new order supersedes the old one.
- **Cancel Both:** Cancel both orders. Used when you want a clean slate.

Different strategies suit different circumstances. A market maker who is re-quoting (sending new bids and asks continuously) might prefer Cancel Resting to ensure their latest quote is the active one. A participant who wants to protect their standing orders would choose Cancel Aggressor.

2.8 Kill Switch

A **kill switch** is an emergency control that immediately cancels every resting order and quote associated with a specific participant or gateway connection.

It can be triggered by: - **The participant themselves:** "Our system is malfunctioning, cancel everything immediately." - **The exchange:** "This participant's behaviour is disrupting the market; we are cancelling all their orders." - **Automatic disconnect handling:** If a gateway connection is lost, the exchange may automatically trigger a kill switch to prevent stale orders from sitting in the book without the participant being able to manage them.

After a kill switch, the participant's connection is typically marked as **inactive**. Before they can re-enter orders, they must reconnect and authenticate. This gives a human a chance to assess the situation before resuming trading.

Kill switches are mandatory features under regulations including MiFID II (EU) and the **Market Access Rule (Rule 15c3-5, 2010)** in the United States. As noted in the *How Exchanges Are Regulated* section of Part I, the Market Access Rule, adopted in November 2010 in the year of the Flash Crash, requires broker-dealers to have pre-trade risk controls and post-trade monitoring, including the ability to immediately halt trading. MiFID II additionally mandates that kill switch functionality be **regularly tested**, it is not sufficient to have a kill switch that works only in theory. Every exchange must demonstrate the ability to cancel a participant's orders immediately when required, and must produce evidence of this capability to regulators on request.

2.9 Mass Cancel, Not the Same as a Kill Switch

These two mechanisms are frequently confused because they both result in orders being cancelled. They serve entirely different purposes and have entirely different consequences for the participant.

Mass cancel is an order management message, a normal, operational request submitted by the participant themselves to cancel multiple orders at once. It is intentional, deliberate, and routine. Examples:

- "Cancel all my resting orders in AAPL", a trader repositioning ahead of earnings.
- "Cancel all DAY orders across all symbols", an end-of-session cleanup.

- "Cancel all my orders on the bid side", a market maker pausing one side of their quotes while reassessing direction.

After a mass cancel executes, the participant's gateway connection remains **fully active**. The participant can immediately submit new orders. There is no interruption to their session, no authentication required, no human review needed. The mass cancel is simply a fast, convenient way to withdraw multiple resting orders with a single message rather than cancelling each one individually.

A mass cancel generates individual cancellation events for each order in the audit trail, exactly as if the participant had cancelled each order manually. From the exchange's perspective, it is indistinguishable from a burst of individual cancel messages; it just arrives more efficiently.

The kill switch, by contrast, is an emergency measure. Its defining characteristics that distinguish it from mass cancel are:

	Mass Cancel	Kill Switch
Who initiates	Participant only	Participant, exchange, or auto-triggered
Gateway remains active	Yes, participant can send new orders immediately	No, gateway is marked INACTIVE
Purpose	Routine order management	Emergency: malfunction, regulatory action, disconnect
Reconnect required	No	Yes, human review before resuming
Audit log entry	Series of cancel events	GATEWAY_SUSPENDED event + cancel events
Can target a subset of orders	Yes (by symbol, side, type)	No, cancels everything for that gateway
Used for scheduled cleanup	Yes	No, misusing it would lock out the participant

A market maker who updates their quotes hundreds of times per second will use mass cancel routinely during the session, for example, withdrawing all quotes when MMP fires, or when they detect a stale data feed. They would never use a kill switch for this; a kill switch would force them to re-authenticate before trading again.

A kill switch is invoked when a system is out of control. A mass cancel is invoked when a system is in control but wants to change its position quickly.

> **Key idea:** Use a kill switch when something has gone wrong and a human must intervene before trading resumes. Use a mass cancel when a participant wants to cancel orders as part of normal operation. The difference is not just functional, it is architectural: the kill switch changes the gateway state; the mass cancel does not.

CHAPTER 3

Self-Match Prevention, When You Would Trade with Yourself

Self-match prevention (SMP) deserves its own treatment because it is one of the most commonly misunderstood features of exchange systems, and because it has both regulatory and operational dimensions.

3.1 The Problem

Imagine a market maker who runs two algorithms simultaneously, one placing bids, another sweeping asks. If the bid algorithm quotes $150.30 and the ask algorithm routes a buy order at $150.30 or higher, the two sides match against each other. No ownership has changed hands; no real trade has occurred. Both sides belong to the same firm.

This is called a **wash trade**. It is problematic for several reasons:

- It generates artificial trading volume, misleading other participants about market activity.
- It creates artificial price pressure (many wash trades in sequence can move a price without genuine supply/demand).
- It is illegal under market manipulation regulations in most jurisdictions (the EU's Market Abuse Regulation, the US SEC's Rule 10b-5, and others explicitly prohibit wash trading).

3.2 The SMP Mechanism

SMP detects the wash condition and applies one of several policies before any fill occurs:

Cancel the aggressor (most common default): The incoming order is cancelled. The resting order remains in the book, available to other participants. Use this when you want to protect your standing quotes from being inadvertently swept by your own algorithms.

Cancel the resting order: The resting order is cancelled; the incoming order continues to sweep looking for a different counterparty. Use this when the new order reflects a more current view of value and should supersede the old one.

Cancel both: Both the resting and incoming order are cancelled. Use this when you want to eliminate both sides cleanly, for example, when re-positioning and wanting neither order to remain active.

Allow the match (no SMP): Some systems permit self-matching in testing environments or for specific account structures where the "two sides" are legally distinct entities despite sharing a gateway ID. In most production environments, SMP is always on.

3.3 How SMP Identifies a Self-Match

How the matching engine identifies orders from the same participant is exchange specific. Exchanges can identify these traders using one or several of the following mechanisms:

- SMP IDs (Self-Match Prevention Identifiers): Market participants register unique identifiers (called SMP IDs at CME, and self-trade prevention or STP/STPF identifiers at other venues, where STPF stands for "Self-Trade Prevention Functionality") with the exchange. When submitting quotes or orders via APIs like FIX or SBE, the trader tags the message with this ID. The matching engine checks for matching SMP IDs on resting and incoming orders to prevent execution.
- Firm/Trader Identifiers: SMP IDs are often paired with firm-level identifiers (such as a Globex Firm ID or Operator ID) to ensure that the cross-matching is coming from the same organization.
- Account Numbers: In some simplified systems, the clearing account or firm account number is used by the exchange to block two orders from the same overarching entity from crossing.
- Cross-Broker Tagging: Some venues allow a participant to use the same self-match identifier across several executing brokers, so that even if a firm routes orders through different brokers, the exchange still recognises them as the same beneficial trader and prevents self-trading.

What is the SBE?

SBE stands for *Simple Binary Encoding*. It is a high-performance, non-textual message protocol designed for electronic trading. It was developed by the FIX Trading Community as a faster alternative to traditional text-based protocols.

- **Binary Format:** Unlike standard FIX protocol which sends data as text (e.g., 35=D;49=FIRM), SBE transmits data as raw binary bytes (zeros and ones).
- **Fixed Position:** SBE uses fixed-length fields or highly predictable schemas. The matching engine knows exactly which byte contains the self-match identifier without needing to scan or parse the entire message.
- **Ultra-Low Latency:** Because computers read binary natively, SBE requires almost zero CPU overhead to decode. This allows algorithmic traders to submit orders, complete with their self-match identifiers, in microseconds.

3.4 Why This Matters for Developers

SMP is implemented inside the matching sweep loop, it runs after price compatibility is checked but before any fill is committed. The code path must handle all three cancellation outcomes, generate appropriate event notifications (the cancelled order receives a cancellation event, not a fill), and continue the sweep to look for non-self counterparties if the resting order was cancelled.

> **Key idea:** SMP is not just a courtesy feature, it is a legal requirement on regulated exchanges. An exchange that facilitates wash trading faces regulatory action. Every exchange system must implement it correctly.

CHAPTER 4

Drop Copy, The Shadow Record

A **drop copy** is a real-time copy of all order lifecycle events for a participant, sent simultaneously to a designated recipient, typically a **clearing broker**, **prime broker**, **risk management system**, or directly to a **regulator**.

The name comes from the physical world: the exchange, or the trader, used to drop a "carbon copy" of each order event to the designated desk as it happened.

4.1 Why Drop Copy Exists

A large institutional investor might have dozens of trading desks, each submitting orders to the exchange through its own gateway. The firm's central risk management system needs to see all order and fill activity in real time to monitor aggregate position and exposure. But having the risk system receive from dozens of separate gateways is complex. Instead, the exchange provides a single drop copy feed that aggregates all activity for that firm, regardless of which gateway originated it.

Clearing brokers use drop copy to see fills on behalf of their clients in real time, so they can begin the clearing and settlement process immediately without waiting for end-of-day reports.

Regulators can mandate drop copy access to monitor for suspicious activity in real time. Under the SEC's 15c3-5 Market Access Rule, broker-dealers are required to have real-time monitoring capabilities; a drop copy feed to an independent risk system is one of the standard ways to satisfy this requirement.

4.2 What a Drop Copy Message Contains

A drop copy event is a complete record of the order lifecycle event. A typical fill notification on the drop copy feed includes:

Field	Purpose
Sequence number	Monotonically increasing counter for this feed
Timestamp	Nanosecond-precision time of the event
Order ID	The exchange-assigned unique order identifier
Client Order ID	The participant's own order reference
Gateway ID	Which connection submitted the order
Symbol	Which instrument
Side	BUY or SELL
Order type	LIMIT, MARKET, etc.
Original quantity	What the order was for
Filled quantity	How much filled in this event

Field	Purpose
Remaining quantity	What is left after this fill
Fill price	Price at which this fill occurred
Order status	NEW / PARTIAL / FILLED / CANCELLED
Aggressor flag	Was this order the aggressive (taker) side?

The fill price and aggressor flag are used by the clearing broker to calculate real-time P&L and determine fee billing.

4.3 Drop Copy vs Market Data

Drop copy is a **private** feed, it contains information about a specific participant's orders, which they would not want published to the whole market. Market data (the order book, trades) is **public**, published to all subscribers. Drop copy is delivered on a separate, secured channel, typically authenticated with the participant's credentials.

4.4 Sequence Numbers and Gap Recovery

Each event in the drop copy includes a **sequence number**, a monotonically increasing counter. If the recipient momentarily loses their connection and reconnects, they can request a replay of missed events using the last received sequence number.

Worked example: the clearing broker's risk system receives sequence numbers 1, 2, 3, 4 and then loses connectivity briefly. When it reconnects, it sees sequence number 7 arrive. It immediately knows events 5 and 6 were missed. It sends a retransmission request: "resend from sequence 5." The exchange replays events 5, 6, 7 over a separate unicast channel. The risk system processes them in order and is now fully caught up before sequence 8 arrives.

Without sequence numbers, the risk system would have no reliable way to detect the gap. It might operate with a stale position view, showing a position of, say, 5,000 shares when the true position is 7,000, until the next end-of-day reconciliation. For a real-time risk management system, this is unacceptable.

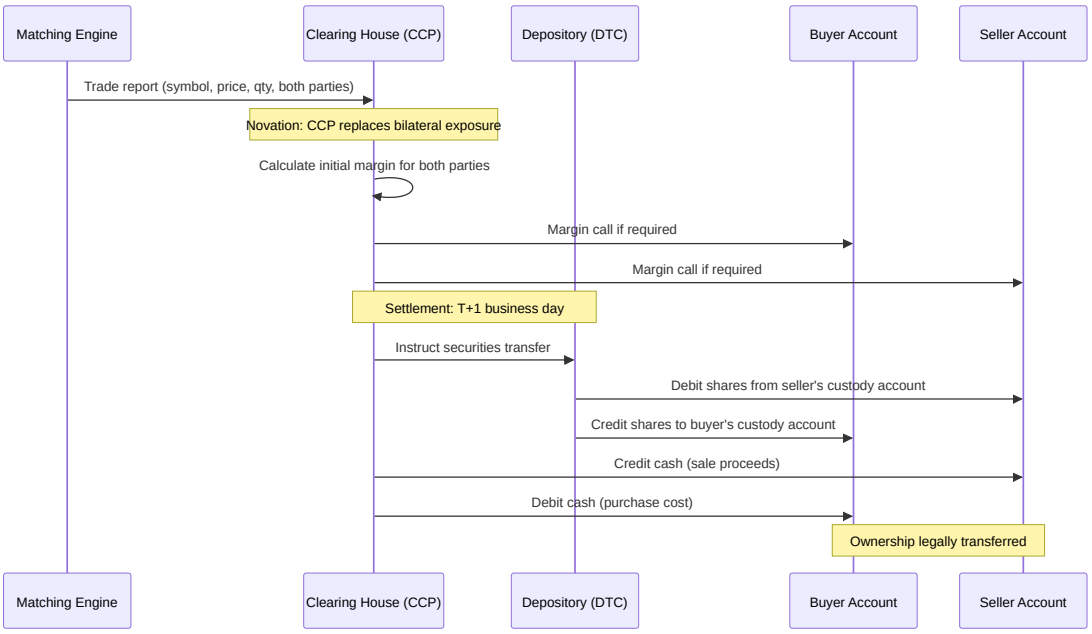
> **Key idea:** The drop copy sequence number is the risk manager's safety net. A system that processes drop copy events without checking sequence numbers for gaps will eventually make risk decisions based on incorrect positions. Sequence integrity monitoring is not optional.

CHAPTER 5

Clearing and Settlement, When the Trade Becomes Real

Matching an order creates a **trade agreement**, two parties have committed to exchange shares and money. But the matching is just the beginning. Before ownership actually changes hands, the trade must be **cleared** and **settled**. Many engineers initially believe that matching equals completion. In reality, matching, clearing, and settlement are three distinct processes with different institutions, different timelines, and different risks.

> **Key idea:** Matching creates an agreement. Clearing determines and guarantees obligations. Settlement transfers assets. All three must succeed before the trade is legally complete. Each involves separate systems and separate institutions.



5.1 What Matching Creates

When the matching engine fills two orders, it creates a **trade record**, an agreement that Participant A will sell X shares to Participant B at price P. At this point: - The shares have not moved. - The money has not moved. - The trade is an obligation, not a completed transfer.

Both parties are now **counterparties** to each other. If either defaults, fails to deliver the shares or fails to pay, the other party suffers.

5.2 Clearing: Guaranteeing the Trade

Clearing is the process by which a third party, the **Central Counterparty Clearing House (CCP)**, steps between the buyer and seller and guarantees the trade will settle, even if one party defaults.

Through a legal process called **novation**, the CCP becomes: - The seller to every buyer. - The buyer to every seller.

After novation, Participant A no longer has a counterparty exposure to Participant B. They have a counterparty exposure only to the CCP. And Participant B has a counterparty exposure only to the CCP. Neither party needs to worry about the other's creditworthiness.

This is transformative for market structure: it means participants can trade with strangers, people they have never met and know nothing about, with confidence that the trade will settle, because the CCP's creditworthiness is the only thing that matters.

Major CCPs: - OCC (Options Clearing Corporation): Clears equity options in the US. - **DTCC (Depository Trust and Clearing Corporation) / NSCC:** Clears most US equity trades. - **LCH:** Major clearing house in Europe and globally, clearing interest rate swaps, equities, and other products. - **Eurex Clearing:** Clears Eurex derivatives and selected equity trades. - **CME Clearing:** Clears futures and options on CME Group exchanges.

5.3 Margin: The Clearing House's Protection

If the CCP guarantees every trade, how does it protect itself from losses if a participant defaults? The answer is **margin**, collateral that participants must post to cover their potential losses.

Initial margin is deposited when a position is opened. It represents an estimate of the maximum likely loss over a short period (typically 1–2 days). For a long position in 1,000 shares of a $150 stock, the initial margin might be 10%, meaning $15,000 deposited as collateral before the position can be held overnight.

Variation margin (also called **mark-to-market**) is the daily cash settlement of gains and losses. At the end of each trading day, positions are revalued at the current market price. If the price moved against you, cash equal to the loss is transferred from your margin account via the CCP. If it moved in your favour, you receive cash. The key point is that losses are realised in cash *each day* rather than accumulating silently. Worked example: you are long 10,000 shares bought at $150. At day's end the closing price is $145. Your variation margin debit is $\$5 \times 10{,}000 =$ **$50,000**, transferred from your account to the CCP. The following day you start with a position valued at $145, not $150. Your total loss can of course keep growing day after day, but the amount the CCP is *owed and has not yet collected* is never larger than one day's move, because every previous day's loss has already been paid in cash.

Maintenance margin is the minimum balance that must be maintained. If losses cause the balance to fall below this level, the participant receives a **margin call**, a demand to deposit additional collateral immediately. Failure to meet a margin call results in the CCP liquidating the position to recover the deficit.

Margin is especially important for derivatives (futures, options) where positions are leveraged and losses can exceed the initial investment. The most consequential demonstration of what happens when margin requirements are inadequate is the **2008 financial crisis**, and specifically the collapse of **Lehman Brothers** on 15 September 2008.

Lehman filed for bankruptcy with over $600 billion in liabilities [Federal Reserve Bank of New York, 2010]. A large portion of Lehman's derivatives exposure was in **OTC (over-the-counter) derivatives**, bilateral contracts negotiated directly between Lehman and individual counterparties, not cleared through a CCP. These contracts had no daily variation margin settlement, no novation, and no independent collateral calculation. When Lehman defaulted, its counterparties discovered that the bilateral collateral arrangements were insufficient to cover the full exposure. The resulting losses, uncertainty about who held what exposure, and the consequent freeze in credit markets contributed directly to the worst financial crisis since the Great Depression.

The contrast with exchange-traded and CCP-cleared derivatives is direct: CME Clearing required daily mark-to-market variation margin on all futures positions. Because the CCP had collected variation margin every

day throughout the life of each position, Lehman's own posted collateral covered the cost of transferring and auctioning off its positions within days, and other clearing members suffered no losses. The same story played out at a far larger scale in London: LCH's SwapClear service had to close out Lehman's interest-rate swap portfolio, some $9 trillion of notional exposure, and did so using only about 35% of the $2 billion of initial margin Lehman had posted [CCP Global, *The Lehman Case*]. The crisis is the strongest argument ever made in favour of mandatory central clearing for derivatives, a principle subsequently enshrined in the Dodd-Frank Act in the US (2010) and the European Market Infrastructure Regulation (EMIR, 2012), both of which require most standardised OTC derivatives to be cleared through authorised CCPs [BIS, 2019].

Historic Note: GameStop and the Margin Call Heard by Everyone, January 2021

The clearest recent illustration that CCP margin is not a paperwork formality, but a real, immediate cash demand, came from an unlikely source: a heavily shorted video-game retailer. In the last week of January 2021, coordinated retail buying (organised substantially through the Reddit community r/WallStreetBets) drove GameStop's share price up more than ten-fold in days, from single digits to an intraday peak above $480, forcing hedge funds with large short positions to buy back shares at rapidly rising prices to limit their losses (a **short squeeze**), which pushed the price up further still.

The part of the episode most relevant to this section happened not on any exchange's matching engine but at the clearing house. As retail brokerages' customer buy orders in GameStop and related stocks surged, the **National Securities Clearing Corporation (NSCC)**, a DTCC subsidiary and the CCP for US equities described earlier in this section, recalculated the **initial margin** brokers were required to post against their unsettled customer trades, and, because margin requirements scale with position size and volatility, both of which had exploded, some brokers faced a demand for additional collateral reported in the hundreds of millions of dollars, arriving with only hours' notice. One retail brokerage, Robinhood, has stated it received a deposit requirement roughly ten times its normal level overnight. Unable to post the full amount immediately, Robinhood and several other brokers **temporarily restricted customers to selling only**, not buying, GameStop and a handful of other names, for several trading days, a decision that provoked a US congressional hearing and lasting controversy about retail-broker risk management and clearing-house margin methodology.

For exchange and clearing system developers, the episode is the sharpest possible demonstration that the margin mechanics described above are not abstract: variation and initial margin are recalculated continuously against real-time volatility and position size, the resulting demand is due in cash within hours, not days, and a broker unable to meet it has essentially no options that do not involve restricting its own customers' access to the market. It also connects directly to two other threads already in this book: the PFOF and retail-order-flow economics described in the *Smart Order Routing* section of Part IV, since payment for order flow is precisely why brokers like Robinhood could offer commission-free trading to the retail participants at the centre of this event, and the borrow-and-locate mechanics of short selling described in Part I, since the underlying trigger was a short squeeze against exactly the hard-to-borrow, heavily-shorted positions that section described. [US House Committee on Financial Services, *Game Stopped: Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, staff report, June 2021; DTCC public statements, January 2021.]

5.4 Clearing Members and the Clearing Hierarchy

Not all market participants have direct relationships with the CCP. The clearing infrastructure is organised in layers:

Direct clearing members (or **general clearing members**) are firms, typically large banks and broker-dealers, that have a direct legal relationship with the CCP. They post margin directly to the CCP and are responsible for guaranteeing trades cleared in their name. They may also clear trades on behalf of others.

Non-clearing members are firms whose trades must be guaranteed by a clearing member. A hedge fund, for example, typically cannot be a direct clearing member of a CCP. Instead, it routes its trades through a **clearing broker** (usually a prime broker who is also a clearing member), who guarantees settlement to the

CCP. The hedge fund posts margin to the clearing broker; the clearing broker posts to the CCP.

This hierarchy matters for exchange developers because the clearing system must track not just which firm traded, but which clearing member guarantees each trade. The risk layering determines who bears the loss if a participant defaults: first the participant's posted margin, then the clearing broker's guarantee, then the CCP's guarantee fund, and finally the surviving clearing members' mutualized contributions. Understanding this chain explains why clearing brokers care so intensely about the credit quality and position size of their clients.

The Panic of 1907 and the Birth of the Lender of Last Resort

On 22 October 1907, depositors ran on the Knickerbocker Trust Company in New York after its president was linked to a failed attempt to corner the copper market. The run spread across the trust companies, call-money rates on the NYSE spiked above 100% annualised, and the exchange's president later recounted that the market came within hours of closing outright. There was no central bank; the crisis was contained because J. Pierpont Morgan personally convened the city's bank presidents, famously locking them in his library overnight, and directed pooled liquidity to solvent-but-illiquid institutions, while the US Treasury deposited federal funds with the banks. The near-miss made the structural point unarguable: a financial system without an institutional liquidity backstop depends on the judgement, balance sheet, and mortality of individuals. Congress responded with the Aldrich–Vreeland Act (1908) and the National Monetary Commission, whose work led directly to the Federal Reserve Act of 1913. The margin spirals, circuit breakers, and CCP default waterfalls described in this Part are all, in a sense, institutionalised replacements for Morgan's library.

References: Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm* (Wiley, 2007) ISBN: 978-0470152638

5.5 Delivery versus Payment (DvP)

Delivery versus payment (DvP) is the settlement principle that the transfer of securities and the transfer of cash happen simultaneously and conditionally: neither the securities nor the cash are released until both are available. This eliminates the risk of one party delivering while the other fails to pay.

The risk DvP is designed to eliminate has a name in financial history: **Herstatt risk**, after the 1974 failure of Bankhaus Herstatt, a small German bank. On 26 June 1974, German banking regulators withdrew Herstatt's banking licence at 3:30pm local time, after the close of interbank settlement in Germany but while the New York foreign exchange settlement was still open. Herstatt had already received Deutsche Mark payments from its counterparties in Germany but had not yet made the corresponding US dollar payments to banks in New York. Those New York banks had delivered value but received nothing, and the abrupt closure meant they never would. The losses and resulting settlement uncertainty froze parts of the interbank market for days [BIS Committee on Payment and Settlement Systems, 2003]. Herstatt risk, the risk that one leg of a settlement transfers while the other fails, is the foundational motivation for the DvP principle.

Without DvP, a seller might deliver shares and then find the buyer has defaulted before paying. DvP ensures atomicity: either both transfers happen or neither does.

5.6 Settlement: The Actual Transfer

Settlement is the final exchange, shares move from the seller's custody account to the buyer's, and cash moves from the buyer's account to the seller's. After settlement, ownership has legally changed.

US equities currently settle on **T+1**, one business day after the trade date. The market previously operated on T+5 (paper certificates and bicycle messengers), then T+3, then T+2 as settlement infrastructure was digitised, and moved to T+1 in 2024 [8]. Some instruments, including many money-market instruments and some US Treasury trades, already settle on the trade date (T+0). Same-day settlement eliminates settlement risk entirely but requires that cash and securities be available at the moment of trading.

5.7 Failed Settlement

Not all trades settle on time. A **failed settlement** occurs when one party cannot deliver, the seller lacks the shares (perhaps their own purchase has not yet settled), or the buyer lacks the cash. Failed settlements create a cascading chain of problems, since other participants may be counting on receiving those shares to fulfil their own obligations.

Buy-ins are a remedy: if a seller fails to deliver shares, the buyer has the right to purchase the shares in the open market at the seller's expense. Buy-ins are relatively rare in liquid markets but are a meaningful operational risk in illiquid or small-cap stocks.

5.8 Custody and Depositories

Custody refers to the safekeeping of securities on behalf of investors. Most investors do not directly hold share certificates, their broker holds shares in a nominee account at a **depository**. The depository maintains the master record of who owns what.

In the US, the **DTCC's Depository Trust Company (DTC)** is the central securities depository, it holds the vast majority of US equity shares. Electronic book-entry transfers between DTC accounts enable settlement without physical movement of certificates.

This dematerialisation (replacing paper certificates with electronic records) is what made T+5→T+3→T+2→T+1 settlement possible. When settlement meant physically moving certificates, five days was genuinely necessary. With electronic records, same-day settlement is technically feasible.

5.9 VWAP and P&L

A clearing system tracks each participant's **position** (how many units they hold, positive for long, negative for short) and their **Profit and Loss (P&L)**.

VWAP (Volume-Weighted Average Price) is the average price paid for a position, weighted by quantity filled. If you buy 100 shares at \$150 and then 50 more at \$160, your VWAP is (100×\$150 + 50×\$160) / 150 = **\$153.33**. Your break-even price is \$153.33; selling above this generates profit, selling below generates a loss. Market participants use VWAP both as a benchmark for execution quality (did you beat the average price over the period?) and as the entry price for P&L calculation.

Unrealised P&L (also called **open P&L** or **mark-to-market P&L**) is the gain or loss on positions that have not yet been closed. If you hold 150 shares with a VWAP of \$153.33 and the current market price is \$160, your unrealised P&L is 150 × \$160 − \$23,000 (what the shares cost you) = \$24,000 − \$23,000 = **\$1,000.00**. (Note that using the *rounded* VWAP, (160 − 153.33) × 150, gives \$1,000.50: fifty cents of error created purely by rounding an intermediate value. Real P&L systems keep the exact total cost, or the VWAP at much higher precision, for exactly this reason.) It is "unrealised" because you have not yet sold and may not receive that price. Unrealised P&L is updated continuously as the market price moves.

Realised P&L is the gain or loss locked in by completed trades. If you sell all 150 shares at \$160, your realised P&L becomes \$1,000.00 and the position is closed to zero. Realised P&L does not change after the trade is done; it is a permanent record of what was earned or lost.

For exchange developers, the distinction matters because position monitoring systems must track both: unrealised P&L is what triggers margin calls and risk alerts in real time, while realised P&L is what flows into the official accounting records at end of day.

CHAPTER 6

Trade Busting and Clearly Erroneous Trades

Every mechanism described so far in this Part, pre-trade risk controls, circuit breakers, price collars, SMP, kill switches, exists to stop a bad trade from happening in the first place. This section covers what happens when prevention fails and a bad trade has already executed. The matching engine has already produced a fill, both counterparties have a legally binding trade, and yet the exchange retains a narrow, rules-based power to undo it.

6.1 Why This Power Has to Exist, and Why It Has to Be Narrow

The *Clearing and Settlement* section established that a matched trade is an obligation between two counterparties, not yet settled, but real and binding. Undoing a trade after the fact is therefore not a trivial administrative action, it reverses a legal commitment, and if exercised carelessly it would destroy the certainty that makes anyone willing to trade on an exchange in the first place. If trades could be unwound at either party's convenience whenever the price moved against them, the exchange's core promise of a fair, final, and trustworthy market would collapse.

At the same time, electronic markets can produce prices that are obviously not real prices, a market order sweeping an emptied book during a liquidity gap, a fat-finger error that slipped past pre-trade controls, or a software malfunction, and holding participants to those prices as if they reflected genuine supply and demand would be its own kind of unfairness. The resolution every major exchange has converged on is a **clearly erroneous execution (CEE)** rule: a narrowly defined, objectively measured, publicly documented threshold beyond which a trade can be reviewed and, if it qualifies, either adjusted to a different price or cancelled (**busted**) entirely.

6.2 How a Clearly Erroneous Determination Works

The core test is **numerical, not subjective**: how far did the execution price move away from a reference price (typically the last consolidated print before the questionable trade, or the pre-halt reference price during a fast market), expressed as a percentage. US exchanges publish a table of thresholds that widen as the reference price falls and narrow as it rises, reflecting the same logic as tick-size price bands (see the *Tick Sizes and Fractional Ticks* section): a given percentage move is far more likely to be a genuine, if sharp, price movement on a low-priced or volatile stock than on a stable, high-priced one.

Reference price	Regular trading hours	Pre-market and after-hours
\$0.00 – \$25.00	10%	20%
\$25.01 – \$50.00	5%	10%
Above \$50.00	3%	6%

(These are the US "numerical guidelines" for single stocks [FINRA Rule 11892; the exchanges' parallel clearly-erroneous rules]. For a **multi-stock event**, the thresholds become 10% when 5 to 19 securities are involved

and 30% when 20 or more are; leveraged ETFs have their thresholds multiplied by their leverage. Rules are revised from time to time, so always consult the specific venue's current rulebook.)

A worked example. A stock's reference price is $150.00, so during regular hours its threshold is 3%. A market sell order sweeps a thin book and executes a slice at $128.00, a $(150 - 128) / 150 = 14.7\%$ move: far beyond 3%, so the trade is a candidate for review. A second slice from the same sweep executes at $146.00, a 2.7% move, just inside the 3% threshold, and stands as a valid trade regardless of how the reviewer rules on the $128.00 print. Clearly erroneous review is applied **execution by execution**, not to an entire order or an entire event, which is why a single aggressive order that sweeps through many price levels can have some of its fills busted and others stand.

The timing window matters as much as the threshold. A participant (or the exchange itself) must typically file a clearly erroneous request within a short window after the execution, commonly 30 minutes under US rules, precisely because certainty needs to be restored quickly; clearing, margining, and downstream position management (see *Clearing and Settlement*) cannot proceed indefinitely on trades that might still be reversed.

Multi-stock events require coordination. Because modern equity markets are fragmented across a dozen or more venues (see the *Smart Order Routing* section of Part IV), a single erroneous-price event, a software bug, a bad data feed, a fast market during a broad decline, can generate questionable trades simultaneously across several exchanges in the same symbol. Exchanges coordinate through their self-regulatory functions to reach a single, consistent busting decision across all venues for the same event; it would undermine confidence in the entire market structure if the identical erroneous trade in the identical stock at the identical moment were busted on one exchange and left standing on another.

6.3 Busting vs Adjusting

Two distinct remedies exist once a trade is found clearly erroneous:

Cancellation (busting). The trade is voided entirely, as if it never happened. Positions and cash movements are reversed. This is the standard remedy when no reasonable price can be assigned.

Price adjustment. Rather than cancelling, the exchange adjusts the trade to a different, non-erroneous price (typically the reference price used in the review, or a price at the edge of the applicable threshold). This preserves the fact that a trade occurred (useful when one party has already acted on the fill, for example, hedged it) while correcting the economically nonsensical part of the print.

6.4 How This Connects to Events Already in This Book

The 2010 Flash Crash (see the *Market Orders* section of Part II) produced the canonical example of both remedies at scale: in the chaotic minutes when the E-mini sell algorithm swept a thinning book, some individual equities briefly traded at $0.01 or as high as $100,000. In the hours that followed, the SEC and the exchanges jointly reviewed the event and **busted trades that were more than 60% away from the pre-crash reference price**, a specific, published, retroactively-applied threshold designed for exactly this kind of extreme, multi-stock, multi-venue event. Positions built on those busted prints were unwound; trades within the 60% band, however uncomfortable, stood.

Knight Capital (see the dedicated cautionary tale in this Part) is the instructive negative case. Despite the scale of the disaster, more than 4 million unintended executions, roughly $6.65 billion of unwanted positions, and a loss of over $460 million, almost none of Knight's trades were clearly erroneous in the regulatory sense. Only trades in six stocks, whose prices had been pushed far enough from their reference prices, were busted; the trades in the other 148 stocks stood, because each execution occurred at or near the prevailing market price at the moment it happened. The runaway code was buying at the offer and selling at the bid: real, fair, non-erroneous prices, over and over again. This is precisely the distinction this section exists to draw: clearly erroneous review is about whether a *price* was divorced from the market at the moment of execution, not about whether a *participant's overall strategy* made any sense. Knight's trades were all individually "clean"; the catastrophe was in the aggregate, uncontrolled volume, which is exactly why the lesson of that chapter is pre-trade and firm-level risk controls, not post-trade busting. The two mechanisms protect against different failure modes and neither is a substitute for the other.

Historic Note: When the Exchange's Own Software Produces the Erroneous Price

The examples above involve a participant's order producing an erroneous price. Twice in 2012, it was the exchange's own matching software that was at fault, both times during an IPO, the single moment an exchange's opening-auction logic is under the most scrutiny and the least room for error.

On **18 May 2012**, a matching-engine defect in NASDAQ's IPO cross process delayed the opening trade of **Facebook** by roughly 30 minutes and left many participants unable to confirm whether their orders had executed at all for hours afterward. NASDAQ ultimately paid a $10 million SEC penalty, then the largest ever imposed on an exchange, for the design and systems-compliance failures, and separately paid roughly $62 million to compensate member firms for losses caused by the malfunction [SEC Release No. 34-69655, May 2013]. No individual trade was "clearly erroneous" in the price sense described above, the defect was in the auction mechanism itself, not in any single order, which is why NASDAQ's remedy took the form of a regulatory settlement and direct compensation rather than a batch of busted trades.

Ten weeks earlier, on **23 March 2012**, **BATS Global Markets** attempted to list its own shares on its own exchange. A software defect in the BATS matching engine caused BATS stock to collapse from $15.25 to a fraction of a cent within roughly 900 milliseconds of the opening print, and the same underlying bug simultaneously disrupted trading in some unrelated symbols, including briefly affecting Apple shares on BATS. BATS withdrew its own IPO within minutes of discovering the fault, before the day's trading had even properly begun, cancelling the erroneous prints as part of unwinding the listing entirely. It remains one of the more pointed illustrations in exchange history that a venue's own listing event is not exempt from its own software defects, and that pre-deployment testing (a theme already covered in the Knight Capital section) applies to an exchange's matching engine every bit as much as to a participant's trading algorithm.

Key idea: Pre-trade controls try to stop a bad trade before it happens; clearly erroneous execution rules are the narrow, threshold-based, time-boxed remedy for when one happens anyway. The test is objective (percentage deviation from a reference price, applied trade-by-trade), the window to act is short, and multi-venue events require coordinated, consistent rulings across exchanges. It is not a general-purpose undo button, and, as the Knight Capital case shows, a trade executed at a real market price is not clearly erroneous no matter how disastrous the accumulation of such trades turns out to be for the firm that sent them.

CHAPTER 7

Regulatory Surveillance, Exchanges Are Not Passive

An exchange does not simply match orders and publish data. It actively monitors for market abuse and is legally required to report suspicious activity to regulators. This section introduces the concepts; developers working on exchange infrastructure will eventually need to understand them because audit trail and surveillance requirements shape the design of event logging, data retention, and monitoring systems.

7.1 Types of Market Abuse

Spoofing. A participant places a large order with no genuine intention to trade, they want to move the visible order book in a way that influences other participants' decisions. Once the desired movement occurs, they cancel the spoof order before it can fill. Spoofing was used extensively in electronic markets before regulatory crackdowns; it is now explicitly illegal in the US (the Dodd-Frank Act, 2010) and the EU (Market Abuse Regulation, 2016).

The most famous spoofing prosecution to date is the case against **Navinder Singh Sarao**, a British trader who operated from his parents' home in suburban London. From 2009 to 2014, Sarao deployed automated software to place large layered sell orders in E-mini S&P 500 futures on CME, orders that were real and visible in the order book but were automatically cancelled before they could fill. These "spoofed" orders created a false impression of selling pressure, causing other algorithms to sell into a book that appeared weaker than it was. The US Department of Justice alleged that Sarao's activity contributed to the market conditions present during the Flash Crash of 6 May 2010. UK authorities arrested Sarao in April 2015; he pleaded guilty in the US in November 2016. The case established that spoofing is prosecutable as market manipulation even when no individual order is fraudulent in isolation, it is the pattern of placement-with-intent-to-cancel that constitutes the offence [DOJ press release, November 2016; CFTC v. Sarao, 2015].

Layering. A variant of spoofing: multiple large orders are placed on one side of the book at various price levels to create the appearance of depth and pressure, then cancelled when the deception has served its purpose.

Wash trading. As described in the *Self-Match Prevention* chapter of this Part. Trading with oneself to generate artificial volume.

Front running. Acting on knowledge of another participant's pending orders before they execute, for example, a broker who sees a large client order about to move the market, and trades for their own account first. Illegal and a serious breach of fiduciary duty.

Insider trading. Trading on material, non-public information. Not an order flow manipulation but handled by the same regulatory framework. The exchange's audit trail is a key source of evidence in insider trading investigations.

Quote stuffing. Flooding the exchange with a high volume of orders and cancellations to consume the matching engine's bandwidth and slow down competitors. A high-frequency trading abuse pattern.

7.2 How Exchanges Detect Abuse

Exchanges run **market surveillance systems**, separate processes that consume the complete audit trail of all events and apply pattern detection algorithms. The key inputs are:

- Every order submission, modification, and cancellation, with precise timestamps.
- Every fill, including which gateway was on each side.
- A record of which orders were placed "close in time" to cancellations, from the same gateway.

Modern surveillance systems flag suspicious patterns (a large order placed and cancelled within milliseconds, many times in sequence) for human review. Some use machine learning to detect patterns that do not match known abuse templates.

7.3 The Audit Trail

The **audit trail** is the exchange's complete, immutable record of every event. Every order that arrives, every modification, every fill, every cancellation, every rejection, each is written to the audit log with a high-precision timestamp. The audit trail must be:

- **Complete:** nothing omitted, even rejected orders.
- **Immutable:** no post-hoc modification.
- **Retained:** regulatory requirements mandate multi-year retention, commonly five to seven years depending on the jurisdiction and the type of record (in the US, for example, SEC Rule 17a-4 requires broker-dealers to keep many trading records for six years, and CAT data is retained for six years).
- **Replayable:** given the audit log, regulators must be able to reconstruct the full state of the market at any past moment.

This replayability requirement is not incidental. It is the reason exchange systems are designed for **deterministic replay**: given the same ordered sequence of events from the audit log, the matching engine must reproduce exactly the same fills, cancellations, and book state. Any non-determinism in the matching engine would make audit trail replay unreliable.

The Consolidated Audit Trail (CAT). In the US, the SEC requires all exchanges and broker-dealers to report order and trade events to a centralised database called the **Consolidated Audit Trail (CAT)**, operational since 2020. CAT is the most comprehensive market surveillance database ever built: it captures every order, modification, cancellation, and fill across every registered US exchange and FINRA venue, correlated by customer account. Before CAT, regulators had to subpoena records from each exchange separately and then manually correlate them. CAT gives the SEC the ability to reconstruct the entire market activity for any customer on any day within hours. For exchange developers, this means every event must be reported to CAT in the required format, within required latency windows, or the exchange faces regulatory sanctions.

Suspicious transaction and order reports. Exchanges are not merely passive data sources. When the surveillance system identifies activity that may constitute market abuse, the venue must act on it. In the EU and UK, the Market Abuse Regulation obliges trading venues (and firms) to file a **Suspicious Transaction and Order Report (STOR)** with the national regulator, such as the FCA. In the US, exchanges, as self-regulatory organisations, investigate and refer suspected abuse to the SEC or CFTC, and broker-dealers file Suspicious Activity Reports. Either way, exchanges have internal compliance teams that review surveillance flags and decide what to escalate. The audit trail is the primary evidence attached to these reports.

> **Key idea:** Every event in the exchange system should be written to the audit log before the response is sent to the participant. The audit log is primary; the matching engine state is derived from it.

CHAPTER 8

A Cautionary Tale, Knight Capital, August 1, 2012

Everything in the *Pre-Trade Risk Controls* section, maximum quantity limits, position limits, kill switches, deployment discipline, exists partly because of what happened to one firm on one morning. The story of Knight Capital is the most important cautionary tale in the history of electronic trading, and every developer who touches exchange-adjacent code should know it.

8.1 The Company

In the summer of 2012, Knight Capital Group was one of the most important firms in US equity markets. As a market maker and broker, Knight handled approximately 10–15% of all US equity trading volume, billions of shares every day across thousands of stocks. It was a highly regarded, well-capitalised firm at the centre of the market structure that had emerged after electronic trading matured.

8.2 The Morning

On August 1, 2012, the NYSE launched a new feature called the **Retail Liquidity Program (RLP)**, designed to attract more retail order flow to the exchange by offering price improvements. Participating firms were required to deploy new software to handle the RLP order types.

Knight deployed new code to its production trading servers. The deployment involved eight servers that handled the firm's market making in NYSE-listed stocks.

Seven of the eight servers received the new code correctly.

One did not.

The eight servers ran Knight's order router, **SMARS (Smart Market Access Routing System)**. Buried in SMARS was a long-unused piece of functionality called **"Power Peg"**, which had not been used since 2003 but had never been removed. The new RLP code *reused* a flag in the order messages that had formerly meant "use Power Peg". On the seven updated servers, the flag now meant "this is an RLP order". On the eighth server, which still ran the old code, it still meant "Power Peg".

Power Peg had been designed to split a large "parent" order into smaller "child" orders and keep sending children until the parent was complete. But years earlier, the code that counted how much of the parent had been filled had been moved elsewhere, so the dormant Power Peg code could no longer tell when to stop. When RLP orders reached the eighth server that morning, it kept sending child orders indefinitely, buying at the offer and selling at the bid, over and over again. It was, in effect, a machine programmed to continuously pay the spread [SEC, *In the Matter of Knight Capital Americas LLC*, Release No. 34-70694, 16 October 2013].

8.3 45 Minutes

At 9:30am, the NYSE opened for trading.

Knight's SMARS system on the one misconfigured server immediately began sending orders into the market.

The orders were technically valid, they passed all of the exchange's pre-trade checks. NYSE processed them correctly. From the exchange's perspective, Knight was simply an aggressive, very active participant.

From Knight's perspective, the firm was haemorrhaging money at a speed no human could track in real time.

Over the next 45 minutes, the misconfigured server's child orders produced more than **4 million executions** in **154 stocks**, for more than 397 million shares. Knight ended up with about $3.5 billion of unwanted long positions in 80 stocks and $3.15 billion of short positions in 74 others, a gross exposure of roughly **$6.65 billion**. The system was continuously entering and exiting trades, losing roughly the bid-ask spread on each round trip, millions of times over, while also accumulating enormous positions that it then had to unwind in a market that knew it was a forced seller.

The warning signs had started even before the open. Between 8:01am and 9:30am, Knight's systems automatically sent 97 e-mails to a group of its staff, each referring to "Power Peg disabled". Nobody treated them as an alarm. Once trading began, the operations desk noticed the anomalous activity almost immediately: error messages appeared, phones rang, and colleagues tried to identify which system was responsible. Then came the cruellest twist. In one attempt to fix the problem, technicians uninstalled the new RLP code from the seven servers where it had been deployed *correctly*, reasoning that the new code must be the culprit. That made things worse: with the new code gone, the reused flag meant "Power Peg" on all eight servers, and the runaway behaviour spread [SEC Release No. 34-70694]. It took roughly 45 minutes to stop it.

By 10:15am the damage was done. Knight announced a pre-tax loss of about **$440 million** the following day; the SEC later put the loss at more than $460 million. Knight's share price fell by roughly three-quarters within two trading days, and the firm no longer had enough capital to continue operating on its own.

8.4 The Aftermath

Knight survived only through an emergency capital injection arranged over the following two days. A consortium of investment firms provided $400 million in rescue financing in exchange for equity stakes that gave them majority ownership. Effectively, Knight Capital ceased to exist as an independent firm. Several months later, what remained of Knight merged with Getco LLC to form KCG Holdings, which was eventually acquired by Virtu Financial in 2017.

8.5 What Went Wrong: A Technical Post-Mortem

The SEC conducted a detailed investigation and published its findings in October 2013, fining Knight $12 million in the first enforcement action under the Market Access Rule. The root causes, in the order they would need to have been addressed to prevent the disaster:

1. Deployment process without verification. Eight servers needed the same software. A manual deployment procedure was used, and it was not verified to confirm all eight servers were identically configured. In any production system where a single misconfigured server can cause catastrophic damage, every deployment must include an automated post-deployment verification step that confirms every node is running the correct version with the correct configuration.

2. Active dangerous code in a production binary. The Power Peg code had not been removed from the codebase, it had merely been deactivated. In a production trading system, deprecated code that can cause harmful behaviour should be removed entirely, not commented out or conditionally disabled. Code that is not present cannot be accidentally reactivated.

3. No position limit or notional limit at the firm level. Knight's pre-trade risk controls were focused on individual order validation, not on accumulated firm-wide exposure. A firm-level position monitor that triggered a circuit breaker when gross exposure exceeded, say, $100 million in a short window would have halted the rogue system after the first few seconds. The system ran for 45 minutes because nothing automatically stopped it when the positions grew to dangerous size.

4. No kill switch, and no plan for using one. The SEC found that Knight "did not have supervisory procedures concerning incident response" and "did not have clear guidance for its technology personnel as to when to disconnect a malfunctioning system". In the chaos of the morning, staff diagnosed, guessed, and rolled back code instead of simply disconnecting. A kill switch that nobody is authorised, trained, or instructed

to pull is not a kill switch. Emergency controls must be pre-tested, clearly documented, instantly accessible, and operable by a single person under extreme stress, with explicit authority to act first and investigate afterwards.

5. No automated detection of anomalous trading patterns. An algorithm sending 4 million orders in 45 minutes, accumulating $7 billion in exposure on one server while the other seven servers show normal activity, should have been automatically detectable. A real-time monitor comparing per-server activity, or watching the rate of position accumulation relative to normal levels, would have flagged the anomaly within seconds. Automated detection should not require a human to notice something is wrong.

6. The exchange cannot protect you from yourself. This deserves particular emphasis. NYSE processed every single one of Knight's 4 million orders correctly. None of them violated any exchange rule. The exchange is not in a position to determine whether a participant's trading strategy makes business sense, only whether the orders are technically valid. Pre-trade risk controls at the exchange level (quantity limits, fat-finger price filters, rate limits) exist to protect the market as a whole from clearly erroneous orders. They are not a substitute for participant-side risk management. Knight's situation could not have been prevented at the exchange level alone.

8.6 The Legacy

The Knight Capital incident triggered a wave of regulatory attention to algorithmic trading risk. The Market Access Rule (Rule 15c3-5, adopted in 2010) was already in effect at the time of the incident and required broker-dealers to have risk controls for market access; the SEC's 2013 order found that Knight's controls had not complied with it.

Subsequently, regulators in the US, EU (under MiFID II), and other jurisdictions tightened requirements for: - Pre-deployment testing of algorithmic trading systems - Kill switch accessibility and testing requirements (MiFID II mandates regular kill switch testing) - Intraday position and notional limits - Automated anomaly detection

Every requirement in the *Pre-Trade Risk Controls* section of this document, and the kill switch discussion, is grounded in part in the lesson that Knight Capital paid $440 million to teach.

> **Key idea:** The market does not stop when your system malfunctions. Every order your system sends is valid in the exchange's eyes until you cancel it or your gateway is disconnected. The only protection against a runaway algorithm is pre-trade risk controls on your own side, deployed correctly, verified after every deployment, and exercisable instantly under pressure.

Glossary

The following definitions are written to be concise and standalone, useful as a quick reference after reading the document.

A

Automated Collar Expansion (ACE): This book's name for rules that, when an instrument's likely price lies outside its protective collar, pause only that instrument, keep collecting orders, and widen the collar in published steps until the indicative auction price fits, instead of either blocking a genuine repricing or trading at an absurd price. Real venues use their own names (Nasdaq's Halt Cross price protections, NYSE's auction-collar extension after LULD pauses, Xetra's extended volatility interruption). See *Price Collars*, Part III.

Adverse Selection: The risk a market maker faces when their quote is hit by a counterparty who has superior information about where prices are heading, causing the market maker to trade at a price that will quickly move against them. A market maker who is repeatedly adversely selected will lose money even while quoting at "correct" prices. MMP exists specifically to limit adverse selection damage.

Aggressive order: (also called a **taker**), an incoming order that immediately trades against resting orders. It "sweeps" the book.

Aggressor / Taker: The participant whose incoming order triggered a match by crossing the spread to meet a resting order. The aggressor "takes" liquidity that was already available. Contrast with *Maker*, the participant whose resting order was already in the book.

Assignment: The process by which an options clearing house (the OCC, in the US) selects which option writer(s) must fulfil the obligation created when a holder exercises. Assignment passes from the OCC to a clearing member and from the clearing member to a specific client, typically via random or FIFO allocation. See *Exercise*, *Pin Risk*.

Automated Market Maker (AMM): A smart-contract-based pricing mechanism used by decentralised cryptocurrency exchanges in place of an order book. Prices are set algorithmically from the ratio of two assets held in a liquidity pool, commonly via a constant-product formula, rather than by matching a buy order against a sell order. See *Decentralised Exchange (DEX)*.

Automatic Exercise: The OCC's practice of exercising any in-the-money option on a holder's behalf at expiry (by a threshold as small as $0.01 in-the-money) unless the holder has filed a contrary instruction. See *Exercise*.

Alternative Trading System (ATS): A trading venue that matches orders but is not a registered national securities exchange. Includes ECNs and dark pools. Subject to lighter regulation than exchanges in some jurisdictions.

Arbitrage: The simultaneous purchase and sale of the same (or equivalent) asset on different markets to profit from a price difference. Pure arbitrage is risk-free (buy cheap here, sell expensive there at the same moment); in practice, most arbitrage involves some timing or execution risk. Arbitrage is the mechanism by which prices on different venues are kept consistent, arbitrageurs quickly eliminate price discrepancies, making markets more efficient. **Latency arbitrage** is a specific form exploiting the time it takes for price changes

to propagate between venues.

Ask / Offer: The price at which a seller is willing to sell. The best (lowest) ask is the top of the sell side of the order book. The collection of all active asks forms the sell side of the book.

ATC (At-The-Close): An order TIF valid only during the closing auction.

ATO (At-The-Open): An order TIF valid only during the opening auction.

Auction / Call Auction / Uncross / Fixing: A trading mechanism where orders are collected over a period and then matched simultaneously at a single equilibrium price. Contrasts with continuous matching where orders match one at a time as they arrive.

Auction Imbalance: The excess of buy orders over sell orders (or vice versa) at the indicative uncross price during an auction. Published by exchanges to encourage offsetting orders before uncrossing.

Audit Trail: The complete, immutable, time-ordered record of every event in the exchange system, every order, fill, cancellation, and rejection, with precise timestamps. Required for regulatory reporting and replay-based recovery.

B

Big Bang: The 27 October 1986 deregulation of the London Stock Exchange, which abolished fixed commissions, ended the broker/jobber separation, permitted outside and foreign ownership of member firms, and replaced floor trading with the screen-based SEAQ system, all on a single day. The UK counterpart to the US's 1975 "May Day." See *May Day*.

Backwardation: A futures market in which near-dated contracts are more expensive than later-dated ones, so a calendar spread priced as near minus far is positive. The opposite of *contango*.

Basis: In derivatives and futures markets, the price difference between two related instruments, most commonly between the spot/cash price and a futures price on the same underlying, or between two futures contracts with different expiry dates. In the implied-order examples in this document (the *Implied Orders and Synthetic Liquidity* chapter of Part II), the spread price of −$2 between the January and February crude oil contracts is the basis between those two contract months: January is $2 cheaper than February. The basis is not fixed; it changes continuously as supply and demand for the near and far months evolve independently. **Basis risk** is the risk that the expected relationship between two instruments diverges unexpectedly, a spread trader who expected the two legs to move together may find they do not, leaving an unintended net exposure. See *Implied Order*, *Calendar Spread*.

Bear Market: A sustained decline of 20% or more from a recent market peak. Originates from the image of a bear swiping its paws downward. Contrast with *Bull Market*.

Best Ask: The lowest resting sell price in the order book, the price at which a buyer can trade immediately.

Best Bid: The highest resting buy price in the order book, the price at which a seller can trade immediately.

Best Execution: The regulatory obligation for brokers and investment firms to take all reasonable steps to achieve the best possible result for their clients when executing orders. "Best" considers price, execution costs, speed, likelihood of execution, and market impact simultaneously, not just the quoted price in isolation. Mandated by MiFID II in the EU and the SEC's duty of best execution in the US. Best execution is the regulatory foundation that makes smart order routing (SOR) necessary: brokers must demonstrate their routing decisions genuinely serve clients' interests, not just the broker's economics.

Bid: The price at which a buyer is willing to buy. The best (highest) bid is the top of the buy side of the order book.

Bid-Ask Imbalance: A measure of depth asymmetry: bid_depth / (bid_depth + ask_depth), computed within a symmetric price window around the mid. Values near 1 indicate heavy buying interest; values near 0 indicate heavy selling interest. Used as a short-term price direction signal.

Blue Chip: A large, financially sound, well-established company, the most prestigious tier of the equity market. The term originates from poker, where blue chips represent the highest denomination.

Bond: A standardised debt instrument. The issuing company borrows money and promises to pay periodic

interest (coupon payments) and return the face value (principal) at maturity. Bondholders are creditors, not owners, and are paid before equity holders in a bankruptcy. Bonds trade on secondary markets after issuance, allowing investors to exit before maturity. The financial term "bond" traces its roots back to the 14th century from the Old English word bindan and band, which eventually evolved into the standard English word "bind". The word was originally used to describe something that literally ties, fastens, or holds things together. Because a financial bond fundamentally operates as a formal, legally binding contract where an issuer promises to repay a loan with interest, the term stuck.

Book-Building: The customary way a conventional IPO is priced: the issuer and its underwriters publish a price range, collect indications of interest from institutional investors during a roadshow, revise the range, and set the final offer price the evening before trading starts. A process of price discovery, not a legal requirement.

Book Depth: The total volume (quantity of shares) resting near the top of the order book. A deep book absorbs large orders without significant price impact. A thin (or shallow) book moves quickly on even moderate order flow.

Book Snapshot: A periodic complete view of the current order book state (all price levels and their quantities) published by the exchange for subscribers who need to get up to speed.

Borrow Rate: The annualised fee charged to a short seller for borrowing shares from a lender. Easy-to-borrow large-cap stocks typically have borrow rates near zero. Hard-to-borrow, heavily-shorted, or illiquid stocks can carry rates of 5–50% or more per annum, applied daily to the short position. Rising borrow rates signal increasing short interest and decreasing availability of lendable shares, and are themselves a market signal.

Bracket Order: A strategy combining an entry order with both a take-profit LIMIT and a stop-loss STOP, typically implemented as an OCO pair.

Broker: An intermediary who executes orders on behalf of clients without trading for their own account. The word traces to Old French/Norse roots meaning someone who opens a cask and sells by the cup, a retail intermediary.

Bull Market: A sustained rise of 20% or more from a recent market trough. Originates from the image of a bull thrusting its horns upward. Contrast with *Bear Market*.

Buy-In: A remedy for failed settlement: if a seller cannot deliver securities, the buyer purchases them in the open market at the seller's expense.

C

Calendar Spread: A derivatives strategy involving the simultaneous purchase and sale of contracts on the same underlying instrument but with different expiry dates, for example, buy the March futures contract, sell the June futures contract. Used to profit from expected changes in the price difference (the "spread") between contract months. On CME and most futures venues it is also a listed instrument with its own order book, priced as near month minus far month; *buying* the spread means buying the near month and selling the far month, so the buyer profits when that difference rises. Spread prices are routinely negative. Requires cross-symbol coordination in the matching engine. See *Implied Order*.

Call auction: Synonym for auction, "call" refers to the fact that all participants are "called" to submit orders before a single price is determined.

Capital Appreciation: An increase in the market price of a share (or other asset) above the price paid. The primary way equity investors generate returns.

Capital Gain: The profit realised when an asset is sold for more than it was purchased for.

Cascade Cancel: When a COMBO order fails (any leg is cancelled or rejected), all remaining unfilled legs of the combo are automatically cancelled. Previously executed fills are not reversed.

CCP (Central Counterparty Clearing House): An entity that stands between buyer and seller in a trade, becoming the legal counterparty to both, eliminating direct counterparty credit risk.

Circuit Breaker: An automatic trading halt triggered when price movement exceeds a threshold within a time window, designed to prevent cascading automated trading crashes.

Clearly Erroneous Execution (CEE): A trade whose price deviates from a reference price by more than a published, price-tiered percentage threshold, making it eligible for cancellation (busting) or price adjustment under exchange rules. Reviewed execution-by-execution within a short time window (commonly 30 minutes); multi-venue events require coordinated rulings across exchanges. Distinct from a trade that is merely unwelcome to the participant who sent it, the test is an objective price deviation, not the sender's intent. See *Trade Busting and Clearly Erroneous Trades*, Part III.

Conformance Testing: The process by which a prospective exchange participant's trading system is verified, against a prescribed test script in a certification (UAT) environment, to correctly implement the exchange's protocol and expected behaviours before being granted production credentials.

Contango: A futures market in which later-dated contracts are more expensive than near-dated ones (common when the cost of storing the underlying is high), so a calendar spread priced as near minus far is negative. The opposite of *backwardation*.

Continued Listing Standards: The ongoing, ordinarily automated compliance thresholds (minimum bid price, market value of public float, shareholder count) a listed company must keep satisfying after its initial listing, distinct from the one-time *Initial Listing Standards*. Breach triggers a deficiency notice and cure period before involuntary delisting.

Crossed Market: A condition where the best bid on one trading venue is higher than the best ask on another venue for the same instrument, a transient artefact of fragmentation and quote-propagation latency across independent venues, and a theoretical risk-free arbitrage opportunity for whoever can act on it fastest. See *Locked Market*.

Cure Period: The window (commonly 180 days, sometimes extended) an exchange gives a listed company to regain compliance with a continued listing standard after a deficiency notice, before involuntary delisting proceedings begin.

Clearing: The process of confirming and recording a trade, and (via a CCP) guaranteeing its settlement.

Co-location: Placing a participant's trading servers physically inside the same data centre as the exchange's matching engine, minimising network round-trip latency to microseconds.

Collar Band / Price Collar: A price filter that rejects orders whose submitted price deviates too far from a reference price. Two distinct variants: the *static price collar* (compares against the last close) and the *dynamic price collar* (compares against the last trade). See those entries for details.

Combo Order: A single instruction to execute orders in multiple instruments simultaneously. Each component is a leg.

Conflation (Market Data): Merging consecutive market data updates for the same price level into a single message under high-load conditions. Reduces message volume at the cost of losing intermediate states.

Continuous Trading: The normal trading mode where orders match as soon as they arrive and a compatible counterparty is present. Contrasts with auction mode.

Contract Multiplier: For futures and options, the dollar (or other currency) value of a one-unit price move per contract. The E-mini S&P 500 has a multiplier of $50, a 1-point move in the index is worth $50 per contract. Essential reference data: a wrong multiplier affects every P&L and margin calculation.

Corporate Action: An event affecting a company's share structure, stock splits, dividends, mergers, delistings. Requires adjustments to all open orders, positions, and reference data in exchange systems.

Counterparty Risk: The risk that the other party to a trade defaults before settlement is complete. Cleared via CCP novation, which replaces bilateral counterparty risk with exposure to the CCP.

Coupon: The periodic interest payment on a bond. Named after the physical coupon strips that bond holders historically detached and redeemed for payment.

Crossing the Spread: Submitting an order at a price that matches an existing resting order, triggering an immediate fill.

Cum-Dividend: The period during which a share trades *with* entitlement to a declared dividend, the buyer receives the upcoming payment. A share trades cum-dividend from the dividend announcement up to (but not including) the ex-dividend date. After the ex-dividend date the share trades *ex-dividend* and the buyer is not

entitled to the payment. The price typically drops by approximately the dividend amount on the ex-dividend date.

CUSIP: A 9-character identifier for US and Canadian securities used in clearing and settlement. Analogous to ISIN.

Custody: The safekeeping of securities on behalf of investors by a broker or custodian bank, with records maintained at a central securities depository.

D

Dark Fibre: Unused optical fibre cable already laid in the ground but not yet carrying data traffic ("lit"). Trading firms and data providers lease dark fibre from infrastructure companies and run their own optical transceivers, creating private, dedicated network links between financial data centres. Dark fibre links are used between major exchange co-location sites (e.g., NYSE in Mahwah and NASDAQ in Carteret) to reduce cross-venue latency for arbitrage and hedging strategies.

Decentralised Exchange (DEX): A cryptocurrency trading venue that executes trades directly via smart contracts on a blockchain, with no central operator holding custody of participant assets and, commonly, no traditional order book, matching instead via an *Automated Market Maker*. Contrast with a *Centralised Exchange (CEX)*, which operates a conventional matching engine and custodies participant assets itself.

Decimalization: The switch from fractional dollar price quoting (eighths, then sixteenths) to decimal cent quoting in US equity markets, phased in between August 2000 and April 2001. Quoted spreads on liquid stocks roughly halved as a direct result. The direct historical motivation for Rule 612's sub-penny quoting floor. See *Tick Sizes and Fractional Ticks*, Part II.

De-SPAC: The merger transaction in which a Special Purpose Acquisition Company (SPAC) combines with a private operating company, resulting in the operating company becoming publicly traded under the (renamed) shell's listing. See *SPAC*.

Direct Listing: A method of going public in which a company's existing shares begin trading on an exchange via the opening auction mechanism, with no new shares issued, no underwriter guarantee, and no pre-set offer price. Contrast with a traditional underwritten IPO. Pioneered at scale by Spotify (2018) and Slack (2019), both on NYSE.

Dark Pool: A private trading venue where orders are not displayed in a public order book. Participants submit orders and are matched against other participants' orders, typically at the midpoint of the NBBO, with the trade only reported publicly after it occurs. Used by large institutional investors to trade without revealing their intentions and causing adverse price movement. Contrast with *lit markets* (public exchanges) where resting orders are visible to all. See *Regulatory Surveillance*.

DAY: An order TIF valid only for the current trading session.

Delivery versus Payment (DvP): The settlement principle that the transfer of securities and cash happen simultaneously and conditionally, neither is released without the other. Eliminates principal risk in settlement.

Depth (Market Depth): The total quantity of resting orders available at each price level. Deep markets can absorb large orders with minimal price impact.

Depth-of-Book (Level 2): Market data showing multiple price levels and their resting quantities, rather than only the best bid and ask.

Designated Market Maker (DMM): A firm assigned by an exchange to maintain fair and orderly markets in specific securities, with both privileges and obligations. NYSE's term; Nasdaq calls them Market Makers.

Determinism (Exchange): The property that given the same initial state and the same ordered input messages, the matching engine always produces identical outputs. Essential for audit trail replay and disaster recovery.

Discounted Cash Flow (DCF): A valuation method that estimates a company's future free cash flows and discounts each one back to today's money at a rate reflecting risk and the time value of money. For young, fast-growing firms most of the result usually sits in the *terminal value*, the lump that stands for all years beyond the forecast.

Dilution: The reduction in existing shareholders' ownership percentage when new shares are issued. Selling 20% of a company to new investors reduces existing owners to 80%.

Dividend: A cash payment made by a company to its shareholders, distributed from retained profits. Not guaranteed, the board of directors decides whether, when, and how much to pay. Companies that pay regular dividends are typically mature, profitable businesses with stable cash flows. High-growth companies often pay no dividend, choosing to reinvest profits in expansion. The key dates are: the *declaration date* (when the board announces the dividend), the *ex-dividend date* (buyers on or after this date do not receive the payment), the *record date* (the register of shareholders eligible to receive payment), and the *payment date* (when the cash is distributed).

Drop Copy: A real-time copy of all order lifecycle events for a specific participant, sent to a designated third party such as a clearing broker or risk system.

DTCC (Depository Trust and Clearing Corporation): The central clearing and settlement infrastructure for US equity markets. Its subsidiary DTC is the US central securities depository.

Dynamic Price Collar (Reference Price Filter): A pre-trade risk control that rejects any order whose submitted price deviates more than a configured percentage from the most recent traded price. Protects against algorithms that walk the price incrementally through a series of small trades. Contrast with *Static Price Collar*, which uses the last close as the reference. Together, the two collars provide overlapping protection against both sudden errors and gradual drift.

E

ECN (Electronic Communication Network): An electronic trading system that automatically matches buy and sell orders, typically with narrower spreads than exchanges but less regulatory oversight.

Equilibrium Price (Auction Price): The single price at which the maximum volume can trade in a call auction.

Equity: Ownership stake in a company. Equity holders (shareholders) have a residual claim on the company's assets and earnings after all creditors are paid.

ETF (Exchange-Traded Fund): A basket of securities (shares, bonds, commodities) that itself trades as a single share on an exchange.

Ex-Dividend Date: The date from which a stock trades without entitlement to a declared dividend. Buyers on or after this date do not receive the dividend.

Execution Algorithm (Algo): Software that breaks a large institutional order into smaller pieces and executes them over time to minimise market impact and achieve a target average price. Common types include VWAP (match the day's volume-weighted average price), TWAP (distribute uniformly over time), Implementation Shortfall (minimise the gap between decision price and execution price), and POV/In-Line (participate at a fixed percentage of market volume). Execution algorithms generate the majority of order flow on modern exchanges.

Exercise: An option holder's invocation of their right to buy (call) or sell (put) the underlying at the strike price. American-style options may be exercised any time up to expiry; European-style options only at expiry. See *Automatic Exercise*, *Assignment*.

F

Face Value (Bond): The principal amount of a bond, the amount the issuer promises to repay at maturity, and the basis on which coupon payments are calculated.

Failover: The process of switching from a failed primary system to a secondary (backup) system.

Fat Finger: Industry slang for an accidental trading error caused by mistyping an order parameter (quantity, price, etc.).

FIFO (First-In, First-Out): Within a price level, orders are filled in the order they arrived. Earlier arrivals have priority.

Fill: An execution, a match between a buy and sell order resulting in a trade. Partial fills consume part of an order; a complete fill consumes all of it.

FOK (Fill-Or-Kill): An order that must be completely filled immediately or cancelled entirely.

FIX (Financial Information eXchange): The industry-standard protocol for electronic order submission, used by most exchanges and brokers globally.

Flat: Having no open position in a symbol (net quantity = 0). Neither long nor short.

Floor Broker: Historically, a broker who executed trades on the physical exchange floor. The term persists in regulations and informal speech.

FPGA (Field-Programmable Gate Array): Reconfigurable hardware chips that can implement market data parsing or order routing in dedicated logic circuits, achieving nanosecond-level latency.

Front Running: Acting on advance knowledge of a pending client order to trade for one's own account before executing the client's order, then profiting from the price movement the client's order causes. Illegal under market manipulation regulations and a serious breach of fiduciary duty. Front running is detected by surveillance systems that flag cases where a participant's own trades immediately precede large client executions in the same direction.

Futures Contract: A standardised agreement to buy or sell a specified quantity of an underlying asset (commodity, index, currency, interest rate) at a predetermined price on a specified future date. Obligations are legally binding. Futures are exchange-traded, margined, and marked-to-market daily. Unlike equity ownership, futures do not represent ownership of an underlying asset, they represent an obligation about a future transaction.

G

Greenshoe (Over-Allotment Option): An option letting IPO underwriters sell up to 15% more shares than the base deal. If the price sags after listing they buy shares back in the market to support it; if it rises they exercise the option and buy the extra shares from the issuer at the offer price.

Gap (Market Data): A missing sequence number in a market data feed, indicating a lost message. Subscribers must request retransmission or resynchronise from the next full snapshot.

Gateway: The participant-facing interface to the exchange. Handles authentication, session management, and message translation.

Going Long: Owning an asset in expectation that its price will rise, so it can be sold later at a profit. You are "long" the asset. The term originates in physical commodity trading: a merchant who had purchased durable goods, grain, spices, metal, cloth, and was holding them in a warehouse was described as "long" in those goods. The word captured both *possession* (you own something tangible) and *duration* (durable goods last a long time and can be held through seasons or years). Being long in modern finance carries exactly the same meaning: you hold the asset and are exposed to its price over time. A long position profits when the price rises and loses when it falls.

Going Short / Short Selling: Selling an asset you do not currently own, typically by borrowing it from another party, with the intention of buying it back later at a lower price and returning it, pocketing the difference. The term originates in physical commodity trading: a merchant who had sold goods they did not yet possess, committing to deliver more than their warehouse held, was "short" of the goods. The same word family as "falling short," "short of supplies," or "shortage", deficient, insufficient, lacking. In the early forward markets of Amsterdam and London, a short seller would sell forward (promise future delivery), then purchase the goods in the market before delivery, hoping prices had fallen. Isaac Le Maire's 1609 campaign against VOC shares is the earliest recorded large-scale short selling operation. Today, a short position profits when the price falls (you buy back cheaper than you sold) and loses when it rises, in theory without limit, since a rising price has no ceiling.

GTC (Good-Till-Cancelled): An order TIF that persists across trading sessions until filled or cancelled.

GTD (Good-Till-Date): An order Time-In-Force variant that keeps an order active until it fills, is explicitly cancelled, or reaches a specified expiry date, whichever comes first. On the expiry date the order is automat-

ically cancelled. Provides the persistence of GTC without the open-ended risk of an order remaining active indefinitely. Requires the exchange scheduler to track each GTD order's expiry and issue the cancellation at the right time.

H

Heap: A data structure that gives O(1) access to the minimum (or maximum) element. Used in matching engines to efficiently maintain best price access.

High-Frequency Trading (HFT): Automated trading strategies that execute very large numbers of orders at extremely high speeds, typically holding positions for milliseconds or seconds rather than minutes or days. HFT firms invest heavily in low-latency infrastructure (co-location, microwave links, FPGAs) to gain speed advantages. Strategies include latency arbitrage, market making, and statistical arbitrage. Controversial because speed advantages can disadvantage slower participants; the subject of the IEX speed bump.

I

Iceberg Order / Hidden Order / Reserve Order: An order that shows only a small visible peak while hiding a large reserve. Each time the visible portion fills, the order replenishes from the reserve.

Imbalance: The difference between total buy and sell quantity at the equilibrium price. Expressed as a side (BUY or SELL) and a quantity.

Immediate-Or-Cancel (IOC): An order that fills as much as possible immediately and cancels any unfilled remainder. Never rests in the book.

Implementation Shortfall (IS) / Arrival Price Algorithm: An execution algorithm that minimises the difference between the *decision price* (the market price when the investment decision was made) and the actual average execution price. IS algos trade faster when the price moves against the position (urgency increases to avoid further shortfall) and slower when price moves favourably. More adaptive and sophisticated than VWAP or TWAP; preferred by quantitative funds whose models predict short-term price moves.

Implied Generation: A count of how many real orders an implied quote combines, minus one. A first-generation implied quote is built from two real orders; a second-generation quote uses a first-generation implied quote as an ingredient and so combines three. Venues restrict how many generations they compute because the work grows explosively. See *Multi-Layer Implied Orders and the Combinatorial Wall*, Part II.

Implied Matching: A technique used in derivatives markets where the exchange combines resting spread and outright orders (in different books) into a synthetic order in a third book, and lets incoming orders trade against it, all contributing orders executing together. For example: a resting spread order to buy March/sell June combined with a resting outright June bid creates an implied March bid. Implemented on CME Globex, ICE, and (as "synthetic matching") Eurex. Implied matching creates no new liquidity: it makes existing orders reachable from another book.

Implied Order: An order derived by the matching engine from a combination of existing spread and outright orders. Not submitted by any participant, computed from pre-existing orders and published in the relevant outright or spread book. When an implied order matches, all contributing orders execute simultaneously and atomically. If any contributing order is cancelled or filled by other means, the implied order shrinks or disappears in the same processing step. Implied orders never act as the aggressor, and at the same price real orders trade before them.

Implied IN: In CME's terminology, an implied order in the *spread* book created from orders in the outright books. Example: a January bid at \$74.40 and a February ask at \$76.60 together imply a Jan/Feb spread *bid* at $74.40 - 76.60 = -\$2.20$.

Implied OUT: In CME's terminology, an implied order in an *outright* book created from a spread order plus an outright order. Example: a January ask at \$75.00 and a Jan/Feb spread *bid* at −\$2.00 together imply a February *ask* at $75.00 - (-2.00) = \$77.00$.

Inactivation (Quote): Automatically cancelling or suspending the surviving leg of a two-sided quote the moment the other leg is filled. The market maker must re-quote both sides afresh within their re-quoting

window. Used in conservative quote refresh policies (Eurex-style). Protects the market maker from being left with a stale unhedged quote after their inventory position has changed.

Indicative Uncross Price: During an auction accumulation period, the price at which uncrossing *would* occur if matching happened at that moment. Recalculated after every order arrival and published as a signal to help participants decide whether to adjust their orders before the actual uncross.

Information Asymmetry: A situation where some market participants have access to information (faster data, better analytics) that others do not, giving them a trading advantage. Auctions reduce information asymmetry by letting all participants submit orders before any execution occurs.

Informed Flow: Order flow that originates from participants who have an informational advantage about near-term price direction, for example, participants who have seen relevant news before others. When a market maker is repeatedly hit by informed flow, they accumulate inventory at prices that are about to move against them. Informed flow is the root cause of adverse selection.

Initial Listing Standards: The quantitative (minimum share price, public float value, shareholder count) and qualitative thresholds a company must meet before an exchange will admit its shares to trading for the first time. Distinct from *Continued Listing Standards*, which apply on an ongoing basis thereafter.

Initial Margin: Collateral deposited when opening a position to cover potential losses. Calculated by the CCP based on the instrument's historical volatility and the position size.

Insider Trading: Trading on material, non-public information, for example, buying shares before a publicly unannounced merger is announced. Illegal in all major jurisdictions. The exchange's audit trail is a key source of evidence in insider trading investigations, as regulators can reconstruct exactly who traded, when, and at what prices relative to when news became public.

Instrument / Symbol: The specific financial product being traded. Each instrument has its own order book.

Internaliser: A broker-dealer that matches client orders internally against its own inventory or other clients' orders, rather than routing to an exchange. A form of OTC secondary trading.

IOC (Immediate-Or-Cancel): A time-in-force (and order type) where an order sweeps available liquidity at the limit price and any unfilled remainder is immediately cancelled. Never rests on the book

IPO (Initial Public Offering): The first sale of a company's shares to the general public, after which the shares are listed and traded on a stock exchange.

ISIN (International Securities Identification Number): A 12-character global identifier for a security, independent of the exchange it trades on. A single company has one ISIN regardless of where its shares are listed.

ITCH (NASDAQ TotalView-ITCH): NASDAQ's binary, message-based market data feed protocol for order book dissemination. ITCH publishes sequenced events such as add order, modify/replace, cancel/delete, executions, and auction/trade messages so subscribers can reconstruct the full limit order book deterministically from the stream. Official specification: NASDAQ TotalView-ITCH 5.0.

K

Kernel Bypass: Technology that allows a network application to communicate directly with network hardware, bypassing the operating system kernel and reducing latency from microseconds to sub-microsecond.

Kill Switch: An emergency control that immediately cancels all resting orders and quotes for a specific participant AND marks their gateway as inactive, preventing new order submission until the participant reconnects and re-authenticates. Triggered by the participant (emergency self-halt), the exchange operator, or automatically on gateway disconnect. Mandatory under most exchange regulations including MiFID II. Contrast with *Mass Cancel*, which cancels orders but leaves the gateway active.

L

Latency: The time delay between an action and its effect. In exchanges, latency is measured in microseconds or nanoseconds. Low latency is a competitive advantage.

Latency Arbitrage: Trading that profits from the brief period between when a price changes on one venue and when that change propagates to another venue.

Layering: A market manipulation practice: placing large orders to create a false impression of market depth, then cancelling them once the desired price movement occurs.

LCH: A major international clearing house, part of the London Stock Exchange Group. Clears interest rate swaps, equities, foreign exchange, and other products.

Leg: One component order within a combo order or spread strategy.

Leg Risk / Legging Risk: The risk that one leg of a combo order fills while another does not, leaving an unintended single-instrument position.

Level 1 Data: The best bid and ask prices and quantities only.

Level 2 Data (Market Depth): The full order book, all price levels and their quantities.

Limit Order: An order to trade at a specified price or better. May rest in the book if not immediately matched.

Limit Up-Limit Down (LULD): A US regulatory circuit breaker mechanism that pauses trading in an individual stock if its price moves outside a percentage band (the "price band") calculated from a reference price. The bands are tighter for liquid large-cap stocks and wider for smaller, more volatile ones. Trades outside the band are not allowed. If the best bid or offer sits exactly at the band (a "limit state") and does not recover within 15 seconds, a 5-minute trading pause begins. Implemented across all US equity trading venues.

Liquidity: The ease with which an asset can be bought or sold without significantly affecting its price. High liquidity = tight spread, large depth, easy trading.

Locate: The process of finding and reserving a source of borrowable shares before executing a short sale. Under US Regulation SHO, broker-dealers must have reasonable grounds to believe shares can be borrowed before accepting a short sale order. "Failing to locate" before shorting is called naked short selling, which is illegal in most jurisdictions.

Lock-Up: A contractual agreement, typically 180 days, under which insiders and pre-IPO investors promise not to sell their shares after an IPO. It is a contract with the underwriters, not a legal rule, and its expiry can put pressure on the share price.

Locked Market: A condition where the best bid on one venue equals the best ask on another venue for the same instrument, a transient artefact of fragmentation and quote-propagation latency. See *Crossed Market*.

Long Position: Owning a positive quantity of shares. You profit if the price rises. Expressed as a positive number P&L ledger.

Lot: The standard unit of quantity for an instrument.

M

Maintenance Margin: The minimum collateral balance that must be maintained in a margin account. Falling below this level triggers a margin call.

Maker: The participant whose resting order was already in the book when a fill occurred. Contrast with *Aggressor/Taker*.

Margin Call: A demand from a clearing house or broker for a participant to deposit additional collateral to restore their margin account to the required level.

Mark-to-Market: The daily revaluation of positions at current market prices, with cash payments made to reflect daily gains and losses. The mechanism by which variation margin is calculated.

Market capitalisation (market cap): The total market value of all a company's outstanding shares, calculated as share price multiplied by the total number of shares in existence. If Apple has approximately 15.4 billion shares outstanding and each trades at $190, Apple's market cap is roughly $2.9 trillion [1]. Market cap is the most widely used shorthand for a company's size. When rankings refer to "the world's largest exchange by listed market cap," they are summing the market caps of every company listed there.

Market Fragmentation: The distribution of trading volume for a single instrument across multiple competing venues, exchanges, dark pools, ATSs, and internalisers. Modern equity markets are highly fragmented; in the US, AAPL may trade simultaneously across a dozen registered exchanges plus numerous alternative venues. Fragmentation improves competition and reduces fees but complicates order routing and best-execution analysis. Regulatory frameworks like Regulation NMS (US) and MiFID II (EU) were introduced partly in response to fragmentation.

Market Impact / Slippage: The adverse price movement caused by a large order sweeping through multiple price levels.

Market Impact Estimation: The process of computing, before order submission, the average price you would pay (or receive) by sweeping through available book levels for a given order size. Derived from the cumulative depth profile. Used by execution algorithms to size order slices and choose between aggressive execution and passive accumulation.

Market Maker: A professional participant obligated to continuously provide both buy and sell prices, ensuring liquidity for other participants.

Market Maker Protection (MMP): An exchange-provided mechanism that automatically cancels all of a market maker's resting quotes when fills arrive at a rate exceeding a configured threshold within a rolling time window. Protects market makers from being rapidly picked off by participants with superior information (adverse selection). After MMP fires, the market maker enters a protection period before re-quoting. Parameters (fill count, time window) are configured per market maker per symbol.

Market Order: An order that attempts immediate execution against available liquidity at the best obtainable prices. It prioritises execution certainty over price certainty, but execution is still subject to exchange state, available liquidity, price collars, and risk controls. A market order submitted during a halt, against an empty book, or rejected by a pre-trade risk check will not fill.

Mass Cancel: A participant-initiated message type that cancels multiple resting orders simultaneously, all orders for a symbol, all orders of a given type, or all orders system-wide. The gateway connection remains active after a mass cancel; the participant can submit new orders immediately. Contrast with *Kill Switch*, which inactivates the gateway and requires re-authentication.

Matching Engine: The core software that manages order books and matches buy and sell orders to produce trades.

Maturity (Bond): The date on which a bond's issuer must repay the face value to the bondholder.

May Day: 1 May 1975, the date the SEC abolished fixed brokerage commissions on the NYSE, ending nearly two centuries of fixed-rate trading and creating the discount-brokerage industry. The US counterpart to the UK's 1986 "Big Bang." See *Big Bang*.

Microwave Link: A radio communications link using microwave frequencies. Between financial data centres, microwave links provide lower latency than fibre-optic cables because radio waves travel faster through air than light through glass.

Mid Price: The average of the best bid and best ask: (best_bid + best_ask) / 2.

Midpoint Peg Order: An order whose price continuously tracks the current mid price (the average of the best bid and best ask). Executes only when a counterparty arrives whose order is also willing to trade at the midpoint. The mid is a *better* price for both parties than the quoted bid or ask, the buyer pays less than the ask, the seller receives more than the bid; the spread is shared rather than fully paid. Provides price improvement at the cost of uncertain execution timing: there is no guarantee a counterparty will appear. Common in dark pools; also supported on IEX on the lit market. Never competes in the regular price-time priority queue, maintained as a separate midpoint matching layer.

MMP Threshold: The fill count and time window that together trigger Market Maker Protection. For

example, "5 fills within 1 second." If this threshold is exceeded, the exchange automatically cancels all of the market maker's resting quotes. The threshold is negotiated per market maker, per symbol, and finding the right value is a key parameter of market making strategy.

Monotonic: Strictly non-decreasing. A monotonic sequence is one where each value is equal to or greater than all previous values. A strictly monotonic sequence is one where each value is strictly greater.

N

Naked Short Selling: Selling shares short without first locating and arranging to borrow them. The seller delivers nothing at settlement, creating a "fail to deliver." Illegal in most jurisdictions under short sale regulations (Regulation SHO in the US). Distinguished from covered short selling, where shares have been located and borrowed.

Nanosecond: One billionth of a second (10 seconds). Modern matching engines record timestamps at nanosecond precision.

NBBO (National Best Bid and Offer): The best available bid and ask prices aggregated across all US exchanges, as required by Regulation NMS. Brokers must offer clients execution at or better than the NBBO.

NAV (Net Asset Value): The total value of a fund's holdings divided by the number of shares outstanding. For mutual funds, NAV is computed daily using the official **closing price** of each holding, one reason the closing price matters so much.

Novation: The legal process by which a CCP replaces the original buyer-seller relationship: the CCP becomes buyer to the seller and seller to the buyer, eliminating bilateral counterparty risk.

NTP (Network Time Protocol): A protocol for synchronising computer clocks over a network. Basic NTP achieves millisecond accuracy; higher-precision variants achieve sub-millisecond.

O

OCC (Options Clearing Corporation): The central clearing house for equity options in the US.

Odd Lot: An order or execution for a quantity that is not a whole multiple of the standard round lot size for that instrument (commonly 100 shares for US equities). Historically excluded from consolidated NBBO and tape data in US equities, a practice being revised under the SEC's market-data-infrastructure rules. See *Round Lot*.

OCO (One-Cancels-Other): Two linked orders where filling either automatically cancels the other.

OHLCV: Open, High, Low, Close, Volume, the five standard summary statistics recorded for each trading session (or any time period). Open: the first traded price. High: the highest traded price. Low: the lowest traded price. Close: the last traded price (the official closing price in a closing auction). Volume: total shares traded. OHLCV data forms the basis of almost all price charts and historical market analysis.

Open Outcry: The historical method of trading on exchange floors, where traders shouted bids and asks and used hand signals in a sunken circular area called a pit. Largely replaced by electronic trading.

Options: Contracts that give the buyer the right, but not the obligation, to buy (a **call option**) or sell (a **put option**) an underlying asset at a specified price (the **strike price**) before or on a specified date (the **expiry date**). The seller of an option takes on the corresponding obligation. Options are priced using models (Black-Scholes being the most famous) that account for time to expiry, volatility, interest rates, and the distance between the current price and the strike. Cboe is the world's largest options exchange.

Order: An instruction to buy or sell a quantity of an instrument at a specified price or better.

Order Book: The central data structure of a matching engine, all resting buy and sell orders for a symbol, organised by price.

Order ID: A unique identifier assigned to each order upon submission. Must be unique across the entire system.

OTC (Over-the-Counter): Trading that occurs directly between two parties without going through an

exchange. OTC trades are less transparent and subject to different regulations than exchange-traded transactions.

OUCH (NASDAQ OUCH): NASDAQ's high-performance binary order entry protocol used by member firms and low-latency trading systems to submit, modify, cancel, and manage orders directly at the matching engine. OUCH is session-based and message-oriented, with exchange acknowledgments and execution/cancel responses that let clients track the full order lifecycle deterministically. Official specification: NASDAQ OUCH 5.0.

P

P&L (Profit and Loss): The financial gain or loss on a trading position.

Passive Order: See *Resting Order*

Payment for Order Flow (PFOF): A practice in which retail brokers receive payment from wholesale market makers in exchange for routing client order flow to those market makers for internalisation rather than to lit exchanges. Market makers pay for retail flow because retail orders have lower adverse selection risk. Effectively banned in the UK since 2012, and banned EU-wide from 30 June 2026 under the 2024 MiFIR review. Legal but controversial in the US, where it subsidises zero-commission brokerages but raises concerns about conflicts of interest and reduced price discovery. See *Best Execution*, *Internaliser*.

Pin Risk: The risk faced by an option writer when the underlying closes at expiry very close to the strike price, leaving the writer uncertain whether automatic exercise and assignment will occur until after markets have closed, with any resulting delivery obligation priced at the strike regardless of where the underlying opens the next session. See *Exercise*, *Assignment*.

Pit: The sunken, octagonal or circular physical trading area on an exchange floor where open outcry trading happened. CME Group operated prominent futures pits in Chicago. Largely dormant today.

Portfolio: A collection of investments held by an investor, typically diversified across asset types (equities, bonds, etc.) to manage risk and return.

Position: A participant's current holding in an instrument, positive (long) if they own more than they have committed to deliver; negative (short) if they have committed to deliver more than they own; zero (flat) if both sides balance. Position tracking is the clearing system's primary responsibility.

Pre-Trade Risk Controls: Checks applied to orders before they reach the matching engine, quantity limits, notional limits, fat-finger filters, credit checks, and rate limiting. The gateway is typically the enforcement layer.

PRE_OPEN: Session phase before the opening auction. Orders are accepted and rest on the book, but no matching occurs.

Presence Obligation: A market maker's contractual requirement to have live two-sided quotes resting in the book for a minimum percentage of the trading session, commonly 85% or more. Prevents market makers from only quoting on easy days and disappearing on volatile ones when liquidity is most needed.

Price Discovery: The process by which the market determines the current fair price of an asset through the interaction of buyers and sellers. A well-functioning exchange enables efficient price discovery: prices reflect all currently available information and update rapidly as new information arrives. Price discovery is one of the three core promises every exchange makes. Poor price discovery, where the traded price diverges significantly from fair value for extended periods, is a sign of market dysfunction.

Price Level: All resting orders at the same price on the same side of the book.

Price-Time Priority: The matching rule: better prices fill first; at the same price, earlier arrivals fill first.

Primary Market: Where new securities are issued and sold for the first time. The company (or government) receives the proceeds.

Primary Site: The active, live data centre running the production matching engine.

Private Company: A company whose shares are not publicly traded, held only by founders, employees, and private investors.

Prospectus: The disclosure document a company must publish before offering securities to the public. In the EU it is governed by the Prospectus Regulation (EU) 2017/1129 and approved by a national competent authority; in the US it forms part of the S-1 registration statement.

Pro-Rata Allocation: An alternative to price-time priority where fills at a price level are distributed proportionally among all resting orders at that level. Common in some futures markets.

Protection Period: The window of time after MMP fires during which a market maker has no active quotes and is expected to assess market conditions before deciding whether and at what prices to re-enter. The duration is typically a few seconds and is defined in the market maker agreement.

PTP (Precision Time Protocol, IEEE 1588): A network clock synchronisation protocol achieving sub-microsecond accuracy. Used in exchange infrastructure to ensure consistent timestamps across distributed systems.

Public Company: A company whose shares are listed on a stock exchange and available to any investor.

Q

Quote: A two-sided order submitted by a market maker containing both a bid (buy) and an ask (sell) simultaneously. Unlike a regular order, the two legs are linked, what happens to one (a fill, a cancellation) triggers a defined response on the other according to the quote refresh policy.

Quote Leg: One side (bid or ask) of a two-sided market maker quote. Filling one leg triggers the quote refresh policy for the other leg.

Quote Refresh Policy: The rule governing what happens to the surviving leg of a two-sided quote when the other leg is filled. Three main variants: (1) cancel both sides immediately, the most conservative, used by Eurex-style inactivation; (2) cancel only the filled side, leave the other active; (3) leave both active. The choice reflects the market maker's balance between speed of re-entry and risk of holding stale inventory.

Quote Stuffing: A market manipulation practice where a participant rapidly submits and cancels a very large number of orders to consume exchange bandwidth, slow down competitors' systems, and create artificial confusion in market data. A form of denial-of-service abuse in electronic markets.

R

Ratchet: The mechanism in a trailing stop that advances the stop price in the favourable direction but freezes it when the market reverses.

Rate Limiting / Throttling: A control that limits the number of orders a participant can submit per unit time. Prevents denial-of-service conditions from algorithmic misfires.

Re-quoting Obligation: A market maker's contractual requirement to post a fresh two-sided quote within a specified maximum delay after either leg of their previous quote is filled or after MMP fires. Failure to re-quote within this window counts against the presence obligation and may trigger penalties. The window is typically measured in milliseconds to low seconds.

Realized P&L: Profit or loss that has been "locked in" through a trade that reduced an open position. Once realized, it cannot be reversed by subsequent price moves.

Reference Data / Instrument Master: The configuration data describing a tradeable instrument, tick size, price scale, session schedule, contract multiplier, trading status, expiry date, position limits. Read by every exchange component; an error propagates system-wide. Treat it with the same rigour as code: version-controlled, tested, applied atomically.

Regulation NMS: A US Securities and Exchange Commission regulation requiring that equity orders be executed at the best available price across all exchanges (the NBBO). A primary driver of US market fragmentation.

Regulation SHO: A US Securities and Exchange Commission rule governing short sales in equity markets. Key requirements: broker-dealers must have a reasonable belief shares can be borrowed before accepting a short sale order (the "locate" requirement); persistent fail-to-deliver situations must be closed out; short sales

must be marked as "short" in order records. Adopted in 2005 to address concerns about abusive naked short selling.

Replay (Exchange): Replaying a recorded sequence of input messages through the matching engine to reconstruct past market states. Requires the engine to be deterministic.

Reserve Refresh Priority: The queue position rule for iceberg replenishment. Most exchanges place a newly replenished iceberg peak at the back of the queue at its price level, equivalent to a brand-new arrival, rather than preserving the original queue position.

Resting Order / Passive Order: An order that has been accepted by the exchange and is waiting in the book for a counterparty.

Retained Earnings: Profits kept within the business rather than distributed to shareholders. A source of self-funding for company growth.

Rolling Window (MMP): The time period over which fills are counted for Market Maker Protection purposes. Fills older than the window are discarded from the count; only fills within the current window matter. For example, a 1-second rolling window means: "if more than N fills have arrived in any sliding 1-second period, MMP fires."

Round Lot: The standard trading unit for an instrument (commonly 100 shares for US equities), used as the basis for distinguishing a normal order from an *Odd Lot*.

Rule 612 (Sub-Penny Rule): The Regulation NMS provision, adopted 2005, prohibiting exchanges, ECNs, and market makers from displaying or accepting quotations in NMS stocks priced at $1.00 or more in increments finer than $0.01. Stocks priced below $1.00 may be quoted in sub-penny increments. See *Tick Sizes and Fractional Ticks*, Part II.

S

Secondary Market: Where existing securities are traded between investors. The issuing company does not receive proceeds. Stock exchanges are secondary markets.

Secondary Site / Backup Site: A standby data centre that can take over exchange operation if the primary site fails.

Securities Lending / Stock Borrow: The temporary transfer of securities from a lender (typically a long-term investor or custodian) to a borrower (typically a short seller) in exchange for collateral and a lending fee (borrow rate). Short sellers must borrow shares before selling short. The lender retains economic ownership (receives manufactured dividends and can recall the shares) but transfers legal title temporarily. Recall risk, the lender demanding shares back at an inconvenient time, is a key risk for short sellers.

S-1 (Form S-1): The registration statement a US company files with the SEC under the Securities Act of 1933 before an IPO. It contains the prospectus, audited financials, risk factors and the *use of proceeds*. Foreign issuers use the equivalent Form F-1.

SEDOL: A 7-character UK security identifier used in settlement and clearing. Analogous to CUSIP.

Self-Match Prevention (SMP): A mechanism that detects when a participant would trade against their own orders and applies a cancellation policy.

Sequence Number: A monotonically increasing counter attached to events (in a drop copy or message feed) to enable detection of missed events and ordered replay.

Session State Machine: The formal model of an exchange's trading day phases (PRE_OPEN, OPENING_AUCTION, CONTINUOUS, CLOSING_AUCTION, CLOSED) and the permitted transitions between them.

Securities Information Processor (SIP): The consolidated, publicly distributed feed aggregating trade and quote data from every registered US exchange into a single tape. Contrast with a *proprietary direct feed*, which an individual exchange sells separately, typically with lower latency and richer content than the SIP. See *Market Data Economics*, Part IV.

Settlement: The final transfer of securities from seller to buyer and cash from buyer to seller. Legally

completes the trade. In the US, equity settlement currently occurs on T+1.

Settlement Method (Derivatives): Whether a futures or options contract settles by cash payment or physical delivery of the underlying asset. Determines post-expiry processing required by the exchange and clearing house.

Shadow Replication / Shadow Mode: An architectural pattern for high-availability exchange systems. The secondary site receives and processes all input messages in parallel with the primary, maintaining an up-to-date copy of the order book, but does not publish outputs or accept participant connections. If the primary fails, the secondary's in-memory state is already current and it can begin accepting inputs and publishing outputs with minimal failover time. More common in production than true active-active matching.

Share / Stock: A single unit of equity ownership in a company. Each share represents a fractional claim on the company's assets, earnings, and votes.

Slippage: The difference between the expected fill price and the actual average fill price, caused by executing against multiple price levels in the book. Large orders in thin books experience more slippage.

Smart Order Router (SOR): Software that evaluates multiple trading venues and routes orders to achieve the best overall execution, balancing price, fees, available depth, and speed.

SmartNIC / Ultra-Low-Latency NIC: A specialised network interface card designed for trading and other latency-sensitive applications. Unlike commodity Ethernet cards, SmartNICs include an on-card kernel bypass networking stack (such as Solarflare's OpenOnload or Mellanox's RDMA), hardware timestamping of incoming packets to nanosecond precision, and CPU offload for networking tasks. Examples include the AMD Solarflare SFN series and NVIDIA Mellanox ConnectX series, widely deployed in exchange co-location environments.

Snapshot (Persistence): A complete dump of the matching engine's state (all resting orders, positions, key data) taken periodically to reduce recovery time by limiting the amount of write-ahead log that must be replayed.

SPAC (Special Purpose Acquisition Company): A shell company with no operating business that completes its own IPO to raise cash held in trust, with the purpose of later merging with a private operating company to take it public without a traditional IPO process. See *De-SPAC*.

Specialist: NYSE's historical term for the designated firm responsible for maintaining fair and orderly markets in a specific stock, including maintaining the physical order book. The modern equivalent is the Designated Market Maker (DMM).

Speed Bump: A deliberate artificial delay applied to all incoming orders to eliminate the advantage of being marginally faster than other participants. Pioneered by IEX.

Split-Brain: A failure mode in distributed systems where two nodes both believe themselves to be the active primary, leading to conflicting actions.

Spoofing: A market manipulation practice: placing orders with no intention of trading to move prices, then cancelling before execution. Illegal under market abuse regulations.

Spread: The difference between the best ask and the best bid. Market makers earn the spread; participants pay it as the cost of immediate trading.

State Machine: A formal model consisting of a finite set of states and explicit rules about which transitions between states are allowed.

Static Price Collar (Fat-Finger Filter): A pre-trade risk control that rejects any order whose submitted price deviates more than a configured percentage from the last official close price. Designed to catch obvious fat-finger errors, an order at $15.00 on a stock trading at $150.00 is almost certainly a decimal error. Because the reference is the previous close, the static collar is stable throughout the trading day. Contrast with *Dynamic Price Collar*, which tracks the most recent trade instead.

Stop Order: A conditional order that is dormant until the market price reaches the stop price, then converts to another order type.

Stop Price: The trigger price on a stop or stop-limit order. The order remains dormant until the market's last trade price reaches or crosses the stop price, at which point it activates and enters the book (as a market

or limit order, depending on type). A buy stop has a stop price above the current market; a sell stop has a stop price below it.

Stop-Limit Order: A stop order that converts to a limit order when triggered. Provides price protection but may not execute if the market gaps.

Stop-Loss: A sell stop order used to automatically exit a losing long position if the price falls to a specified level.

Surplus: The absolute difference between cumulative buy and sell quantity at the equilibrium price, the quantity that cannot be matched.

Sweeping: The process of an aggressive order filling against resting orders at successive price levels.

T

T+1 / T+2 Settlement: Settlement occurring 1 or 2 business days after the trade date. The US moved from T+3 to T+2 in 2017 and to T+1 in 2024.

T+2 Settlement: Settlement occurring two business days after the trade date. The US standard until 2024; most US equities now settle T+1. T+2 remains the standard in many other markets.

Tick: The minimum price movement for an instrument.

Tick Count / Tick-Based Price: A price represented as an integer number of minimum increments, rather than a decimal. Tick counts are exact; floating-point decimals are not.

Tick Size: The value of one tick, the minimum price increment for an instrument.

Tick Size Pilot Program: A US SEC study (October 2016 – October 2018) that widened the tick size to five cents for roughly 1,200 small-capitalisation stocks to test whether coarser ticks improve market-making economics and liquidity for thinly traded names. Results were mixed: quoted spreads and costs for small trades rose, displayed size at the best prices rose sharply, but the hoped-for improvement in overall liquidity and capital formation did not appear, and no permanent wider-tick regime was adopted. See *Tick Sizes and Fractional Ticks*, Part II.

Tick-to-Trade Latency: The time from when a market data message leaves the exchange to when an order based on that message is received by the exchange. A key performance metric for market makers and HFT firms.

Ticker / Ticker Symbol: The abbreviated code identifying a tradeable instrument (e.g., AAPL for Apple Inc.). Named after the mechanical stock ticker machine that printed trade prices on paper tape using telegraph signals in the late 19th and early 20th centuries.

Ticker Tape: The narrow paper strip printed by the stock ticker machine, showing a continuous stream of trade symbols, prices, and volumes. The source of the term "tick" (minimum price movement) and related concepts.

Time-In-Force (TIF): The attribute specifying how long an order remains valid (DAY, GTC, IOC, FOK, ATO, ATC).

Top-of-Book (Level 1): Market data showing only the best bid price, best ask price, and their quantities. The minimum information needed to understand the current market.

Total Addressable Market (TAM): The total revenue available if a company captured 100% of its market. Often narrowed to the serviceable addressable market (SAM) and the share realistically obtainable (SOM). Popular in growth-company IPO pitches, and notorious for being stretched.

Trade: An executed match between a buy and sell order. Also called a fill or execution.

Trailing Stop: A stop order whose trigger price automatically advances in the favourable direction as the market moves, protected by a fixed trail offset.

TWAP (Time-Weighted Average Price Algorithm): An execution algorithm that distributes a large order evenly across equal time intervals, regardless of trading volume. Simple and predictable, but less adaptive than VWAP. Used when a stock has no reliable volume profile or when the trader wants mechanically

consistent participation. Performance is measured against the average of prices during the execution window, not the overall day's VWAP.

Two-Sided Quote: A market maker's simultaneous bid and ask for the same instrument. Both sides must be live at the same time to fulfil the two-sided quoting obligation. A one-sided quote (only bid or only ask) is a contractual breach of market maker obligations.

U

UUID (Universally Unique Identifier): A 128-bit identifier designed to be unique without central coordination. UUID v4 is randomly generated; UUID v1 incorporates the current time and network address.

Underpricing: Setting an IPO offer price below what the market will pay, visible as a first-day price jump. The gap multiplied by the number of shares sold is called money *left on the table*.

Uncross The single atomic batch execution that occurs at the end of an auction phase. All crossable orders execute at the **equilibrium price** simultaneously.

Unrealized P&L The theoretical profit or loss on an open position if it were closed at the current market price. Changes continuously as the market moves. Becomes realized P&L when the position is closed.

V

Variation Margin: Daily cash payments reflecting mark-to-market gains and losses on open positions. Prevents losses from accumulating to unmanageable levels before settlement.

Venture Capital (VC): Private investment firms that provide funding to early-stage companies in exchange for equity stakes, before those companies are large enough to go public.

VIX (Volatility Index): A real-time index calculated by Cboe from the prices of S&P 500 options, representing the market's expectation of 30-day price volatility in the S&P 500. Commonly called the "fear gauge", when markets are uncertain or falling sharply, participants buy put options for protection, driving up option prices and therefore the VIX. Values above 30 typically indicate high market stress; values below 20 indicate relative calm. Derivatives on the VIX itself trade on Cboe.

VWAP (Volume-Weighted Average Price): The average price of a position weighted by the quantity traded at each price. Used as cost basis for P&L calculation. VWAP $= \frac{\sum(\text{price}_i \times \text{qty}_i)}{\sum \text{qty}_i}$\$

VWAP Algorithm: An execution algorithm that slices a large order and executes it throughout the day in proportion to expected trading volume, more during high-volume periods (open, close) and less during low-volume periods (mid-day). The goal is to achieve an average execution price close to or better than the day's volume-weighted average price. The most widely used institutional execution benchmark. Distinct from *VWAP (Volume-Weighted Average Price)*, which is a measurement; the VWAP algorithm is the execution strategy aimed at matching that measurement.

W

Wash Trading / Wash Trade: A transaction where the same participant is on both sides, generating artificial trading volume with no real change of ownership. Illegal in all major jurisdictions under market manipulation regulations (the EU's Market Abuse Regulation, the US SEC's Rule 10b-5, and others). Also called a wash sale. Sometimes performed accidentally, see *Self-Match Prevention (SMP)*, but when deliberate, it is a form of market abuse used to inflate trading volume figures or create false impressions of liquidity.

Write-Ahead Log (WAL): A persistent, append-only log of all input messages to the matching engine. Written before processing; used for recovery and replay. The source of truth from which all derived state (the in-memory order book) can be reconstructed.

Z

ZeroMQ (ZMQ): A messaging library providing efficient pub/sub, push/pull, and other communication patterns. Commonly used as the message bus in exchange systems. Uses a broker-less PUSH/PULL and PUB/SUB topology. No external message queue server is required.

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The authoritative academic and practitioner reference for all derivatives. Chapter 12 covers trading strategies involving options in detail, spreads (bull, bear, box, butterfly), combinations (straddles, strangles, strips, straps), with numerical examples and payoff diagrams. The chapters on futures also cover calendar spreads and the basis. Hull grounds everything in put-call parity and arbitrage relationships, which is what makes synthetics work. More mathematical than Natenberg but more complete.

[**14**] *Oliver Gingold and "blue chip" (1923-1924):* The attribution of the first financial use of "blue chip stocks" to Dow Jones employee *Oliver Gingold* circa 1923-1924 is widely repeated in financial dictionaries (including Merriam-Webster). The reference used here comes from **Philadelphia University**, Blue Chip term. Note

the $200/share figure attached to Gingold's original usage is a nominal 1923 dollar amount; it has no bearing on "blue chip" classification today and should not be read as a price threshold (see the discussion in *Before the Exchange*, Part I).

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A personal favourite, because it quietly dismantles concepts you were certain you understood. Take interest: you think you know what it is? Probably not. At the very least you will come away knowing how the *effective interest rate* on a loan ought to be calculated, and why an effective rate of a few million percent is rather less alarming than it sounds. In the EU this figure must, by law, be quoted on every instalment-based payment, which has inspired businesses to develop a remarkable repertoire of entirely legal "tricks" for arriving at the lowest quotable number.

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The primary source for the Tick Size Pilot Program discussion in the *Tick Sizes and Fractional Ticks* section of Part II, including the pilot's design (control group plus three five-cent test groups across roughly 1,200 small-cap securities) and its mixed empirical findings.

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The primary legal record of the FTX collapse, cited in the *Cryptocurrency and Digital Asset Venues* section of Part IV as an illustration of counterparty risk when matching, custody, and clearing are not institutionally

separated.

- **Wikipedia:** https://en.wikipedia.org/wiki/Trial_of_Sam_Bankman-Fried
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- **DOJ:** https://www.justice.gov/archives/opa/pr/samuel-bankman-fried-sentenced-25-years-his-orchestration-multiple-fraudulent-schemes

Exchanges own technical references

Publicly available technical specifications and documentation provide exact structural logic and algorithmic details for combo and implied/synthetic orders across major electronic matching engines.

CME Globex Matching Engine & Implied Logic

CME Group provides open-access engineering wikis that map out their continuous multi-leg matching models.

- **Implied Orders Functionality:** To read the explicit state constraints, calculation boundaries, and engine generation rules for "Implied-In" and "Implied-Out" routing structures, visit the CME Globex Implied Orders Documentation.
- **Options-Specific Implied Generation:** For data regarding RFQ-triggered timers and second-generation restriction models, see the CME Globex Implied Options Documentation.
- **Algorithmic Match Priorities:** To inspect how implied quantities interact with Pro Rata or FIFO allocation passes when competing with outright resting orders, review the CME Globex Matching Algorithms Reference.
- **Implied Orders:** CME Group, *Client Systems Wiki, Implied Orders* (overview of implied IN / implied OUT functionality, per-product enablement, and implied dissemination on MDP3): https://cmegroupclientsite.atlass (search: "Implied Orders")

Cboe US Options Complex Book Architecture

Cboe details its execution logic for multi-leg derivative allocations, net premium sorting, and atomicity verification.

- **Technical Specifications Library:** Access the complete engineering documentation library, covering binary order entry and auction layout parameters, via the Cboe U.S. Options Technical Specifications.
- **Complex Book Fundamentals:** For an structural layout of multi-leg order handling constraints and leg ratio normalization, review the Cboe Titanium Complex Order Basics.
- **Complex Book Process Guide:** To dive into the complete structural manual—detailing Signed Values on the Complex Book (debit vs. credit), order sorting mechanisms, and Complex Order Auctions (COA)—view the comprehensive Cboe Titanium Complex Book Process Document.

Intercontinental Exchange (ICE) Order Books

ICE manages highly nested energy and financial spreads that utilize synthetic order generation.

- **Implied Prices and Generations:** ICE's FAQ on implied prices, including the Sep/Oct/Nov multi-generation example used in Part II: ICE Futures Implied Prices.
- **Market Data & Connectivity Controls:** For foundational parameters on data fields, systemic electronic metrics, and electronic volume calculations within the ICE infrastructure, refer to the Intercontinental Exchange Connect User Guide.

NYSE Pillar (Equity Trading Platform)

The core documentation for understanding order behavior, priority categories, and amendment rules across the NYSE (New York Stock Exchange) platform

- Pillar is NYSE technology platform which enables members to access NYSE equities and options markets using standard protocols, NYSE Pillar
- The structural and architectural details are broken down in the official NYSE Pillar Functional Differences Guide. This resource outlines how market collars, auction imbalances, and continuous trading interactions operate inside the core matching engine.
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Some specific facts in this document are well established in the historical and financial literature but could not be attributed to a single verifiable primary academic document within this text, but rather second hand sources such as NYSE own publications and posts. For example:

Closing auction volume: The share of daily volume executed in US closing auctions varies by year, instrument, and calendar (it spikes on index rebalancing days); the figures in the text are from BMLL's 2024 analysis cited above. See The shifting dynamics of the NYSE Closing Auction

Back-Cover Text

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About the Author

Johan Persson is a software engineer and musician with over 30 years of experience in high-performance, safety-critical systems. He has worked in multiple fields in software design and among them modern financial trading systems, as well as with thruster design for satellite control systems. Johan is passionate about making complex systems understandable and accessible and actually enjoys writing documentation. Johan lives in Sweden with his family and enjoys playing banjo (5-string, of-course!), cycling, wood-working, and when time allows, doing electronics design for analog computers.

As a companion to this book Johan has also written an educational exchange platform `EduMatcher` which implements many of the techniques discussed in this book. While out of necessity it is simplified compared with real exchanges it is still a surprisingly complete multi-process, message-bus based trading platform that can run on a laptop. It uses its own protocol suit with names that is a wink to the fintech industry; ALF, BALF, CALF, RALF, and LALF, with ALF=**AL**most **F**ix, BALF=**B**inary **ALF**, CALF=**C**hannel **ALF**, RALF=**R**econcilliation **ALF**, LALF=**L**ogging **ALF**. It makes an excellent companion to run while reading this book!