

## FTEN Calls for SEC to Ban "Naked Access"

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By Nina Mehta

A technology vendor in the sponsored-access arena is calling for the Securities and Exchange Commission to ban "naked access." The firm, New York-based FTEN, defines "naked access" as sponsored access to exchanges by non-broker-dealers with no pre-trade risk filters on that order flow.

Over the last half-year, sponsored access has gained prominence on the SEC's agenda. At an industry conference on market structure last week, James Brigagliano, co-acting director of the SEC's Division of Trading and Markets, noted that risks associated with sponsored access "could affect the integrity of the market structure itself." He stressed the "vital importance of dealing with these issues effectively," and said the Commission would address them in the coming months.

There is industry support for the SEC tackling the broad issue of sponsored access to the markets. But the complication, for some industry participants, is that too many forms of market access may currently be getting pushed under the sponsored-access umbrella, causing confusion and perhaps diluting regulatory focus on the type of access that is considered potentially dangerous to the marketplace.

Sponsored access refers to arrangements that allow firms to send orders directly to exchanges using the member firm's identifier. FTEN, a technology firm that provides risk management services, would like the SEC to prohibit a segment of that flow from reaching the market. "Sponsored access by non-broker-dealers with no pre-trade risk controls is a problem," said FTEN founder Ted Myerson. "It's a problem for the clearing firm, it's a problem for the firm's other clients, and it's a problem for the firm's counterparties."

The problem with this type of unfiltered flow is that a runaway algorithm operated by a non-broker-dealer, for example, could shoot thousands of orders into the market before it is caught and shut off. Other problems could also affect the prices of stocks in the market and expose clearing firms as well as exchanges to large financial and operational risks.

This type of sponsored access is the result of the need for speed by high-frequency trading firms. Firms whose orders do not run through pre-trade risk controls have an advantage over those that do, noted Gary LaFever, chief corporate development officer at FTEN. The pre-trade risk

controls could take one-fifth of a millisecond, he said, but in the world of high-frequency trading, that's too long.

"This liquidity has taken the place of traditional market makers and is therefore valuable to the market," LaFever said. "But if we don't put governors around this liquidity, it gives unregulated entities benefits over those who want to do it right." He added that the availability of sponsored access without pre-trade risk filters also works as a disincentive for these trading firms becoming broker-dealers.

In an April letter to the SEC, FTEN suggested a series of "minimum pre-trade risk management best practices" around sponsored access provided to non-broker-dealers. These types of risk controls, the firm said, could be provided by FTEN, other third-party technology firms, prime brokers' internally developed systems, or, in some cases, exchanges. Exchanges, however, cannot provide the full panoply of services since they typically see only a portion of a customer's flow, LaFever told Traders Magazine.

John Jacobs, director of operations at Lime Brokerage, agrees with FTEN that naked access by non-broker-dealers should be banned. Many of Lime's customers are high-frequency trading firms, but Lime does not give them naked access to the markets. The broker argued to the SEC in February that sending order flow to exchanges without proper pre-trade risk controls is dangerous.

"I agree with FTEN's renaming the practice naked access," Jacobs said. "The current terminology is confusing because a lot of people use the phrase 'sponsored access' in a variety of ways. This redefines the subset of sponsored access that's a problem."

Like FTEN, Lime doesn't worry about brokers sending flow into the market via sponsored-access arrangements. "Sponsored access is okay when one broker-dealer is sponsored by another to piggyback on their exchange membership," Jacobs said. "That's not a problem. The problem is non-broker-dealers going directly into the market unchecked." All broker-dealers, unlike non-brokers, are regulated entities.

Sponsored-access flow accounts for a large portion of U.S. equities volume. Research firm TABB Group estimates that about 66 percent of equities volume comes from high-frequency trading firms. FTEN believes that half of that flow, or 33 percent of the overall market volume, is not subject to pre-trade risk filters. However, that 33 percent includes flow from both broker-dealers and non-brokers using sponsored-access arrangements to reach the markets.

The issue of sponsored access has gotten more airtime since Nasdaq, in January, proposed a new regime around sponsored-access arrangements. Nasdaq's rule proposal was written at the behest of the SEC, with the Commission's guidance. The industry expectation is that any proposal that wins SEC approval would be duplicated by the other exchanges to avoid differences in requirements around sponsored access at various market centers.

The Nasdaq proposal laid out three categories of sponsored access. These include traditional direct-market access, in which a firm sends orders through an exchange's broker-dealer member;

access through a third party such as an execution management system, via an arrangement with the firm's broker-dealer; and direct access that does not pass through the broker's systems.

The proposal generated controversy by tying various types of market access together under one rubric. At the Securities Industry and Financial Markets Association conference where Brigagliano spoke last week, Lauren Mullen, assistant general counsel for global equities at Bank of America Merrill Lynch, said Nasdaq's proposal clouds the issue. It does this, she said, by "talking about the DMA product right next to the sponsored-access product." In her view, brokers already have sufficient controls around DMA flow.

Mullen also noted, however, that the imposition of pre-trade risk controls is "completely at odds with the fundamental nature of the sponsored-access product because the trading does not pass through the broker-dealer's pipes." The SEC needs to "balance having those kinds of [pre-trade] protections with preserving the fundamental nature of the product," she said. "You don't want to backdoor-ban the product." She told the audience that stronger due diligence could address the concerns that have been raised.

Lime Brokerage's Jacobs brings up another sponsored-access issue that his firm would like to see addressed. Exchanges, he said, have no mechanism to enable brokers to automatically end a customer's trading session if an algo runs amuck or keeps spitting orders into the market. "We can't programmatically cancel orders that shouldn't have been placed," he said. "The mechanism to stop it at an exchange is the phone." He added that Nasdaq and NYSE Arca have web portals for member firms to control customers' trading sessions, but that they don't provide automatic or sufficient risk controls for those members, including safeguards needed to limit potential problems.

In Jacobs' view, what exchanges should put in place to control sponsored access responsibly is an "executive port." That, he said, would allow the broker-dealer to turn off a customer's sponsored-access trading session and automatically cancel all open orders if the broker's systems identify a problem with the customer's orders. Nasdaq and NYSE Arca could not comment in time for this article.

In addition to conducting pre-trade risk checks on sponsored-access flow by non-brokers, broker-dealers, according to Jacobs, should monitor real-time drop-copy reports of flow sent to the markets by those firms. In addition, he said, brokers should perform "shadow order validation" based on the drop copies. From Lime's perspective, these minimal checks are necessary to identify potential problems as they arise.

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