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Naked Access Bashed at STANY Roundtable

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Brokers, vendors and exchanges took turns criticizing a controversial form of "sponsored access" at a roundtable convened Wednesday by the New York chapter of the Security Traders Association. The practice under the microscope is access to markets by a broker-dealer's customers with no pre-trade intermediation, supervision or risk management checks performed by the broker.

Goldman Sachs said it is no fan of this type of access. Dariush Nazem, vice president and head of business development for low-latency solutions at Goldman, said brokers providing access to the markets should observe internal risk protocols to ensure that their clients are not taking undue risks that the broker is not comfortable with.

When it comes to sponsored-access arrangements, Nazem said, the industry should "make sure it's a product offering that protects not only the client but the broker-dealer involved." Forms of sponsored access in which the broker is aware of what the client is doing on a pre-trade, during-trade and post-trade basis, and can control those risks, are part of an acceptable product offering, in Goldman's view.

Sponsored access with no pre-trade risk controls is becoming known as "naked access." Ted Myerson, founder and president of FTEN Inc., a vendor that facilitates sponsored access and that sponsored the roundtable, said naked access should be banned by regulators.

In Myerson's view, the stakes are high. Sponsored firms can trade a lot and trade very quickly. Errors can propagate through the system very rapidly, leading to systemic risk. He noted that proprietary trading firms engaging in high-frequency trading, including those getting sponsored access, may also take large positions. His firm saw "one single black box take a position of $1 billion in one second," he said. Myerson added that these firms rely on "sub-millisecond speed to seize momentary price fluctuations."

In addition to conducting fast, sub-second trading, these firms have holding periods of very short duration and massive computing power, said Jamil Nazarali, a managing director and head of electronic trading at Knight Capital Group. There's little human intervention in the trading business of these firms.

If there's a bug in a firm's software or a computing problem, "everything it does can be amplified millions of times over," Nazarali said. This is a particular worry for firms whose order flow gets skimpy or no risk checks before it hits the market.

Research firm Aite Group estimates that about 60 percent of equities market volume comes from high-frequency trading firms. A small subset of that is from non-broker-dealers getting direct sponsored access to the markets.

The Securities and Exchange Commission is considering a set of new rules that may be imposed around sponsored-access relationships. Nasdaq earlier this year recommended new requirements around three types of sponsored access. The three types are traditional direct-market access, in which the customer routes orders to the market through a broker-dealer; access to the markets via a technology vendor, based on a contractual relationship between the vendor and the firm's broker; and direct access whereby the trading house sends flow directly to the markets via its own pipes. In all these cases, the broker whose mnemonic or market participant ID is used is responsible for the trades.

The third access method is what causes the most concern. Naked access is a subset of this category. Regulators and exchange executives worry that orders may not be vetted for compliance and financial risks if they are not subject to the broker's risk controls.

David Harris, CEO of the CBOE Stock Exchange, a small equities exchange with a number of sponsored-access participants, said one concern of his about sponsored access is when there is uncertainty in tracking down information on a post-trade basis. When his exchange is conducting surveillance and sees something that requires attention, "we must know who to call," he said. "And the broker-dealer must know who the customer is." Sometimes brokers are not able to immediately identify which customers sent which orders to the market under their name, Harris said.

No one at the STANY panel defended naked access. They did all note that many firms getting sponsored access, along with other high-frequency shops, benefit the market by providing liquidity. The liquidity they provide narrows spreads, dampens volatility, and allows other traders to get in and out of positions at very low cost, according to panelists.

One high-frequency trader noted that brokers should be careful about the access they give customers. Steve Crutchfield, director of operations at Matlock Capital, reminded the audience that broker-dealers have a know-your-customer obligation. As part of this, he said, it's critical for brokers to understand the technology and systems used by their clients. "The financial skills really do need to be coupled with the technology skills" to ensure that brokers can manage the risks to which they're exposed, he said.

Crutchfield suggested that the "technology certification process" required for some sponsored-access arrangements could be made more rigorous in the current environment of fast, low-latency trading. Matlock is the trading arm of Blair Hull's family office, and has about two-dozen traders running high-frequency and volatility strategies in equities, options and futures. The firm also makes markets on the Chicago Board Options Exchange.

Knight's Nazarali sounded a final cautionary note about sponsored access generally. He pointed out that the presence of risk filters and controls in sponsored-access arrangements does not eliminate risks. "Just because someone is getting sponsored access [with adequate risk management] doesn't mean that risk is removed," he said. The broker-dealer, as well as the marketplace, still remains exposed to risks resulting from a client's trading across multiple asset classes and multiple brokers.