
Could 'triple-A' approach to pre-trade checks resolve sponsored access debate?



Responsibility for pre-trade risk checks in sponsored access offerings should be assigned to those firm in the best position to perform them rather than giving the job entirely to one specific group in the transaction chain, says Gary LaFever, chief corporate development officer and general counsel at high-frequency trading technology firm FTEN.

On 19 January, the US Securities and Exchange Commission (SEC) proposed a new rule – 15c3-5 – under the Securities Exchange Act that would require brokers providing sponsored access or direct market access to implement pre-trade risk controls. The aim is to abolish 'naked' sponsored access, which permits a non-exchange member to trade directly on an exchange without going through its broker's trading infrastructure or pre-trade risk checks. This method of market access is typically employed by high-frequency shops in a bid to avoid the additional latency imposed by the broker's risk management layer.

Since the proposal emerged, debate has focused on whether the SEC is right to impose the risk-checking responsibility on brokers, with some arguing that execution venues are better placed.

However, LaFever argues that asking what FTEN calls the 'triple-A' questions can help determine which market constituent should be responsible for a particular check, i.e.: who has access to the necessary information to perform the checks?; who has the ability to exert effective controls?; and who has the authority to do so? "If you look at any risk control question through those three lenses, it helps the discussion evolve toward specific guidelines," he says. "It is possible to allow different people in the chain to have control over different checks if they are the ones that have the information."

LaFever believes that order-level checks, typically binary yes/no questions that determine whether the order has the right number of shares, has the right value or is in a restricted stock, can adequately be performed by a trading venue.

However position-based checks, which monitor whether a client is exceeding its committed capital level or buying limit, would be difficult for an exchange to impose because it only gets to see the orders sent to it. Brokers, collectively at least, would have an overview of a client's entire trading activities.

"Order-level checks are important but they are not the solution to avoiding systemic risk," says LaFever. "The systemic checks, which I believe are more of the focus of Rule 15c3-5, are risk checks that measure the position, capital consumed, profit and loss. This requires a knowledge at the account level and real-time knowledge of how the account sits within the overall market conditions."

A number of responses to the SEC's proposal expressed concerns about duplication of risk checks in cases where brokers were sponsoring other brokers' access to trading venues. However, LaFever believes FTEN's triple-A approach should help avoid any unnecessary friction.

"If different risk checks are allocated properly to those with the necessary information to make it effective, there is no need to give the checks to multiple parties," he says. "We think there is a way of allocating the risks checks and the preventive measures so the whole industry benefits without creating a lot of latency, inconsistencies or opportunity for arbitrage."

It is so far unclear whether the SEC will mandate specific checks to particular participants in the transaction change or leave the new rule more open-ended. However, LaFever thinks a more principles-based approach would be a mistake, leading to competition over who can implement the least stringent – and therefore the quickest – risk controls. This in turn could lead to concentrations of risk at those firms with the fastest and least-intrusive access solutions.

"If you leave it up to the risk-checker to determine and analyse what the appropriate risk check should be, you create the potential for regulatory arbitrage," says LaFever. "To avoid systemic risk, we propose that the regulator mandate specific checks."

The period for submitting comments on the SEC's proposed sponsored access rule closed on 29 March. The SEC will now consider the responses to determine whether or not to implement the rule.