

SEC Proposes To Ban Naked Access, Set Risk Management Standards

January 13, 2010

[John Hintze](#)

The Securities and Exchange Commission voted unanimously Wednesday to propose new rules on how risks must be managed when brokerage customers are given direct access to electronic markets.

These requirements will include a mandate to check risks before orders to execute trades are sent to electronic exchanges and other trading systems, which would in effect be a ban on so-called "naked access" to markets.

Earlier in the day, the commission approved a Nasdaq proposal for similar rules on the practice of dealers sponsoring access to markets using the dealer's participant identification codes.

The anticipated proposal is aimed at addressing recent concerns about "unfiltered" or "naked" access, in which a broker-dealer lends its exchange identification code to customers who use it to trade directly on exchanges without pre-trade monitoring by the broker-dealer.

The proposal would also require broker-dealers to establish, document and maintain a system of risk management and supervisory controls to manage their various market-access risks, including those arising from customers.

"We are concerned that order-entry errors in this setting could suddenly and significantly make a broker-dealer or other market participants financially vulnerable within mere minutes or seconds," said SEC Chairman Mary Schapiro in her opening statement.

Schapiro noted estimates that naked access accounts for 38% of daily equity trades in U.S. Markets, and she referred to an instance in on September 30, 2008, in which a single market participant accidentally generated enough erroneous trades in a stock to slash its price by 93%.

Schapiro's comments came hours after the regulatory arm of the New York Stock Exchange said it had fined Credit Suisse \$150,000 for poorly supervising the development and execution of an algorithm that clogged the exchange's order processing system on November 14, 2007, with 600,000 messages on seven securities in a 20-minute period. The case illustrated the risks involved, even though the algorithm was being used by an in-house trader and not a dealer's customer gaining "naked access" to markets.

"Today, with the direction given by the SEC, we believe the standard of care and the requirements for the broker has increased from "know your client" to 'know your client's trades in real-time, before they are executed,'" says Ted Myerson, founder and CEO of FTEN.

FTEN is a technology vendor in which several major Wall Street firms including Goldman Sachs and Credit Suisse own a minority stake and that has aggressively promoted the pre-trade risk checks its software enables. At least three smaller, regional broker-dealers—Penson Worldwide, Wedbush Morgan, and Genesis Securities—apply risk checks immediately after trades occur, using market-center confirmations.

In fact, Commissioner Kathleen Casey noted “powerful market participants” seeking regulations to create a level playing field, which in the case of sponsored access would require significant technology expenditures on the part of the broker-dealers not yet monitoring orders pre-trade. “That [level playing field] roughly translates to market share and regulatory advantage,” Casey said.

Casey recommended the commission examining the entire market structure before deciding on specific issues such as sponsored access, given that market developments to date have resulted in tighter spreads, lower execution costs and other benefits for investors.

The SEC also approved a proposal Nasdaq made in January 2009 to institute new rules around sponsored access. David Shillman, associate director in the SEC’s division of trading and markets, noted at the hearing that the SEC’s proposal and Nasdaq’s rule have similar requirements by, for example, requiring risk-management controls to be operated by the broker-dealer and not outsourced to a third party. He added the SEC’s proposal goes beyond Nasdaq’s rule by standardizing the requirements across all market centers and expanding the requirements to agency brokerage and other non-direct-market-access trading.

The SEC proposal specifically requires broker-dealers to:

- Create risk-management controls which prevent the entry of orders that exceed pre-set credit or capital thresholds, or that appear to be erroneous and caused by accident in a so-called “fat finger” event.
- Create controls to assure compliance with all market-access regulatory rules.
- Automatically apply financial and regulatory risk management controls on a pre-trade basis before orders are routed to an exchange or ATS.
- Maintain risk controls and supervisory procedures under the direct control of the broker-dealer with market access.
- Establish, document and maintain a system to review regularly the effectiveness of those controls and procedures