

SECURITIES INDUSTRY | **NEWS**

Putting Clothes on Naked Access

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It's an understatement to say that high-frequency trading, supported by sponsored access, has impacted the structure of the market and affected the way traders, brokers and exchanges do business.

Today we typically see speeds of thousands of orders per second, which means one firm's black box algorithm can build a very large position-billions of dollars-within minutes. And high-frequency traders build these positions by using the market participation identification codes of their sponsoring brokers to access these markets directly.

If these firms, which are un-regulated entities, are sponsored by undercapitalized brokers and enter the market without risk mechanisms in place, a practice referred to as "naked access," there are obvious risks to the financial securities marketplace. The broker may have to cover a position gone bad-and not be able to cover the loss involved. The ripple effect of "naked access" is obvious.

Naked access recently came under increased public scrutiny from the Securities and Exchange Commission. On October 27, Mary L. Shapiro, Chairman of the SEC, likened unfiltered by unregulated entities to exchange systems to "giving your car keys to a friend who doesn't have a license and letting him drive unaccompanied."

I liken this car to a Ferrari without brakes.

A week later, I moderated a panel on sponsored access at the FIX Protocol Electronic Trading conference.

During the panel, Dave Shillman, the associated director of the Division of Trading and Markets at the SEC, Jeff Davis, the vice president and deputy general counsel of NASDAQ and Rishi Nangalia, head of product and business development at Goldman Sachs Electronic Trading spoke about this high-growth sector. We all agreed that naked access is becoming very prevalent as brokers compete for clients based on low fees and high speed, while risk tools are believed to add cost and latency. They also all agreed - and I did, too - that naked access is not good. It may pose a systemic risk to the securities marketplace.

Although some practitioners would argue that naked access is not explicitly illegal today, many sponsoring brokers have opted to use risk management tools while continuing to support high-frequency trading. They do this to protect their businesses from the chance that massive unsupervised trading could go awry, despite the possibility of competitive repercussions.

Several exchanges have risk gateways that apply order-level risk checks before execution to protect the exchange from so-called fat finger mistakes-where order quantities or values are incorrect. The

most famous recent example is the \$31.5 billion computer-driven mistake executed after market hours in Japan.

However, these exchange risk tools have severe limitations. They only provide awareness of trading activity on an individual exchange. Since many high-frequency clients trade across multiple venues, this makes visibility into the client's overall position across markets nearly impossible.

Consequently, many brokers have integrated 'account level' real-time risk systems into their high frequency trading infrastructure, which can be co-located near exchange matching engines. These systems can be built internally or by a third-party, but are managed by the broker, much like traditional direct market access. Since the client's start of day positions and all subsequent orders pass through the broker's infrastructure, these risk systems can process account level risk checks. Account-level risk checks provide the ability to manage capital usage and limits and monitor position across exchanges. They can also stop the order flow, if needed.

Since naked access is clearly a threat to the efficient and safe operation of markets, it's also clear that risk checks will soon be required. And that the presence and capabilities of these risk systems will be the focus of new federal rules and regulations. The SEC said it will build upon the NASDAQ OMX Group's proposed rule, updated in October, to control the risks.

In the modified rule, summarized by Jeffrey Davis during the panel, NASDAQ defines the type of trading relationship based on the type of risk system in place.

If orders pass through a broker-managed infrastructure, it is considered direct market access and not sponsored access. Thus, new SEC rules on sponsored access would not apply.

If the orders pass through a non-broker or service bureau system but use a sponsor's ID, this would be considered sponsored access. Further clarification is needed surrounding the definition of a non-broker/service bureau system.

The SEC plans to build on NASDAQ's proposal and further define "who controls the controls" and whether risk checks should be applied before, during or after the trade. Shillman said these rules will define the type of risk that should be addressed by risk checks, such as protection against erroneous trades, ensuring that sufficient capital is in place to cover trades and any credit risks are identified and evaluated. However, the SEC will not specifically address the exact risk checks that must be applied.

Over the last year my company, FTEN, has made a concerted effort to educate the industry and foster dialogue on these issues. Unfiltered, or naked access presents serious implications to brokers, clearing firms, traders, counterparties and the markets overall.

Now, this hot-button issue has come to the forefront of the regulatory agenda. None too soon. So long as regulatory ambiguity exists, there will continue to be a run toward naked access. As a result, the industry remains at risk of potential systemic damage at a time when our economy and public confidence can least afford it.

Ted Myerson is chief executive of FTEN, a technology company which provides an electronic platform for the execution of high-frequency trades. The platform includes risk controls.