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Nasdaq's Sponsored Access Proposal Could Impose Contractual Burdens

March 2, 2009
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The Nasdaq Stock Market's proposal to establish standard sponsored-access rules could saddle broker-dealers and their clients and technology vendors with new contract requirements that make the arrangements significantly more onerous.

Nasdaq, prompted by the Securities and Exchange Commission, proposed the rules Jan. 22 as a way to address growing concerns about systemic risk. A less expansive proposal was filed by the New York Stock Exchange in October; on Feb. 20, NYSE received approval for its pre-trade risk management system.

Although firms broadly support standardizing sponsored access rules--which currently vary from exchange to exchange--letters issued in response to Nasdaq's proposal have been uniformly critical, if for different reasons. The Securities Industry & Financial Markets Association (Sifma) on Feb. 26 wrote that existing sponsored-access rules are sufficient and the Nasdaq changes would burden brokers and their customers--a sentiment shared by many in the industry.

The Nasdaq plan has caused a stir by extending requirements beyond the traditional realm of sponsored access, where a broker-dealer allows a firm to use its MPID, or market participant identifier, to trade directly on the exchanges. In such arrangements, the orders of the user--typically brokers or hedge funds--do not pass through its sponsoring broker's risk management and compliance systems.

Nasdaq's proposal, however, extends the sponsored-access concept to direct-access arrangements in which a broker-dealer allows a client to use its trading platform. In a direct-access relationship, the orders of the client are subject to the pre-trade risk management controls--technology that is developed in-house or supplied by a third-party company--of the broker's platform.

Sifma would like to preserve the status quo, which relies on contracts to ensure that brokers and their clients adhere to exchange rules, but it calls Nasdaq's requirements too demanding and intrusive. Lime Brokerage, a New York-based provider of direct access, has been highly critical of the contractual approach and favors pre-trade risk management. Commenting on NYSE's proposal, Lime chairman Mark Gordon called traditional sponsored access "analogous to allowing airline passengers to screen their own baggage."

In a Feb. 17 letter on Nasdaq's proposal, John Jacobs, Lime's director of operations, said that sponsored access is a "de facto grant" of exchange membership to a non-broker-dealer and, thus, in violation of Section 6 (c)(1) of the Securities Exchange Act. He concluded that "it is always the broker-dealer's obligation to monitor, supervise and control all activities that occur under its name." Brokers, argue Lime, should have to examine client orders before they are sent for execution.

FTen, a provider of pre-trade risk-management systems in New York, unsurprisingly draws a similar conclusion. "With contracts, if there's a big enough risk, there may end up being no one around to cut the

check” to provide recourse, said Gary LaFever, director of corporate development at FTen, in an interview.

However, Michael Barth, EVP at OES MarketGroup, a provider of order-routing technology, wrote that his firm was unable to find any indications of abuse or regulatory actions “that would illustrate the unacceptable risks involved in existing practices, and therefore require extensive modification of sponsored-access rules.”

While Nasdaq already requires members to have contracts with their sponsored users, it plans to introduce a requirement that broker-dealers’ vendors have contracts with their clients. According to Manisha Kimmel, executive director of the Financial Information Forum, a technology trade group, the proposal is contrary to past guidance from Nasdaq, which “explicitly states that the compliance obligation falls with the broker-dealer and not with any third-party vendor that they use.”

The proposal’s language can also be interpreted in various ways, heightening concerns among, for instance, clearing firms, which often use service bureaus to provide technology to their broker clients. Harvey Cloyd, CEO of Los Angeles-based Electronic Transaction Clearing, noted that the proposal could be extended to online brokerages and their users--and to the vendors the brokers use.

Even if restricted to sponsored-access providers, Nasdaq’s authority to enforce such contracts is questionable. “To require these firms to execute and maintain individual agreements with each of the sponsored participants of a member firm is not only unduly burdensome and redundant but would be of no meaning or consequence, given the fact that these firms do not fall under the jurisdiction of the exchange or any other securities regulatory body,” wrote Cloyd Feb. 5.

Brian Hyndman, SVP of transaction services at Nasdaq, countered that vendors’ agreements with sponsored users “contain the provisions required by the rule for the benefit of the sponsoring member.” He told Securities Industry News that “sponsoring members, of course, remain responsible for ensuring compliance with all rules.”

Sifma noted that because sponsored access would not exist without the exchanges’ consent, the venues “must own some level of responsibility for ensuring that sponsored order flow does not have a detrimental impact on the market as a whole.”

In fact, Nasdaq offers its Pre-Trade Risk Management (PRM) system, which can accept data from NYSE and its Arca platform at a member’s request, to develop a more complete picture, according to Hyndman. “We’re working with BATS Exchange and Direct Edge ECN,” he added, though no date has been set.

Following the implementation of faster trading technology, NYSE has developed a similar service for its Risk Management Gateway. Initially it will provide pre-trade risk management only for NYSE orders, but the exchange operator is considering “extending the service to other execution destinations, hopefully this quarter or the next,” said David Litner, SVP of engineering at NYSE Technologies.

Nasdaq declined to comment on whether, as a provider of risk management technology, it will require contracts between members and their clients as well as between the exchange and those clients. If it doesn’t, that could put third-party vendors at a competitive disadvantage.

Those vendors argue that their systems provide a more complete and dynamic risk picture than the exchanges currently can. “In today’s increasingly cross-asset, multi-exchange, multi-broker environment, exchange-offered sponsored-access risk systems fall short of fully mitigating systemic risk because they inherently lack a cross-market awareness,” said FTen in its comment letter.