

The View from Batterymarch **EQUITY TRADING INSIGHTS****Naked Access and the Impact on Risk Control**

Dragan Skoko, Batterymarch's Director of Trading, explains how "naked access," which gives certain traders direct entry into equity trading venues, benefits a relatively small number of firms while bypassing traditional risk management systems.

Trading on US stock exchanges such as Nasdaq and the NYSE, as well as on Electronic Communication Networks (ECNs) is conducted by member firms, including FINRA-registered brokers and proprietary trading firms. Non-members are permitted to send orders to exchanges through registered brokers via sponsored access, for which they pay fees.

In the current "maker-taker" pricing model, so-called sponsored clients are largely able to offset these fees, along with the razor-thin commissions they pay to sponsoring brokers, by collecting the rebates that exchanges and ECNs would otherwise typically offer to brokers for adding liquidity to the market.

Orders placed through sponsored access have traditionally passed through the sponsoring broker's infrastructure before being sent to an exchange, with the broker's pre-trade risk management system running each order through a number of filters. This screening process is designed to ensure that every order complies with size requirements, credit limits and other criteria established between exchanges and sponsoring brokers, and between sponsoring brokers and their non-member sponsored clients.

In recent years, a new form of sponsored access—naked, or unfiltered access—has altered this process. With naked access, sponsored firms use the sponsoring broker's Market Participant Identifier (MPID) to send trades, sometimes thousands per second, directly to an exchange while sidestepping the broker's trading infrastructure. This gives them a distinct advantage by speeding up order placement and execution.

However, naked access also transfers the operational function of risk management from the sponsoring brokers to their sponsored clients. In other words, responsibility for ensuring that every order meets securities regulations and pre-established, contractually obligated risk criteria rests not with highly regulated, well-established FINRA members, but with proprietary trading firms that are mostly unregulated.

Since 2005, the use of naked access has climbed from just 9% of all US stock trading to 38% in 2009. Hedge funds and proprietary trading firms, which often deploy high-frequency trading and other short-term trading strategies—are reaping the rewards through low broker commissions, financial rebates and faster execution. These advantages are generally not realized by asset managers and individual investors, though current technology has admittedly reduced their trading costs on average, particularly on the retail side.

At present, there is no standardization across US exchanges with respect to sponsored access, from its basic definition to the risk management rules and contractual obligations for sponsoring members. Within the past year, Nasdaq and the NYSE have each proposed new rules and introduced new technologies to address various aspects of sponsored access, with the goal of reducing the potential of a systemic risk control failure.

Such a failure, resulting from a breakdown in a sponsored client's risk management procedures, could slow the trading system or cause it to crash as an excessive number of messages floods the exchange—potentially hundreds of thousands or even millions of orders or order modifications. A systemic failure of risk controls could also lead to large directional moves in a stock or group of stocks due to outsized orders. Due to technological advances, wide-scale failures can span minutes rather than hours whether or not their causes are risk-related, as in the 1,000-point "flash crash" of May 6, 2010 or the Black Monday crash of 1987.

The SEC recently proposed rule 15c3-5, "Risk Management Controls for Brokers or Dealers with Market Access," under the Securities Exchange Act of 1934, which many believe will effectively prohibit naked access on any exchange or broker-sponsored Automated Trading System (ATS). As the benefits of sponsored access are enjoyed by only a small group of market participants, with operational risk shifting from longstanding, regulated member firms to their loosely regulated clients, it seems clear that banning naked access and standardizing the rules for sponsored access in general would benefit the US market structure as a whole.

Banning naked access should not have an adverse effect on market liquidity. We believe that as long as sponsored clients gain financial rewards from exchanges and ECNs, those engaged in rapid trading will not significantly reduce their trading activity, whether or not naked access remains legal.

Important Information

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