

Brokers Call for 'Naked' Exemption

Traders Magazine Online News, February 19, 2010

James Ramage

Two of the biggest sponsors of unfiltered access into the country's exchanges are gearing up to fight a Securities and Exchange Commission proposal intended to kill the business.

Brokerage and clearing firms Wedbush Securities and Penson Financial Services say a proposed rule requiring them to implement pre-trade risk checks on their orders should not apply to them, because their clients already perform such checks.

"I think the idea of having a broker-dealer do it twice is kind of a problem," said Jeff Bell, executive vice president of Wedbush's clearing and technology group.

"Regardless if there's sponsorship or not, a broker-dealer is responsible for making sure that they meet all of these various requirements."

In January, the SEC proposed regulations targeting the practice of sponsored access. Sponsored access refers to arrangements broker-dealers construct that let select market participants send orders directly to exchanges with minimal latency and without passing through the broker's infrastructure. By comparison, direct-market-access orders pass through the sponsoring broker's infrastructure.

The SEC has honed in on pre-trade risk checks as the differentiating factor. Orders that reach an exchange without pre-trade risk checks do so through unfiltered, or "naked," sponsored access.

Pre-trade checks, the SEC argued, "help prevent erroneous orders, ensure compliance with regulatory requirements and enforce pre-set credit or capital thresholds." The SEC said pre-trade risk checks on orders are vital to protecting the integrity of the markets. Such checks increase latency, which is inimical to all sponsored-access customers' high-frequency-trading strategies.

Wedbush and Penson object to the SEC's blanket approach to the issue and are pushing the regulator to qualify its proposal. They contend that exchange rules already require exchange member broker-dealers to check their trades before sending them out.

But if the proposal becomes a rule, the firms said they'd have to start incorporating pre-trade risk checks into their processes--an unnecessary redundancy, they argue. Both firms are angling to find a compromise during the comment period that would preserve their current sponsored-access business models.

The SEC released its proposal on sponsored access on Jan. 13, the same day it approved a Nasdaq rule on the subject. Nasdaq had been laboring for four years to set rules for sponsored access.

Both Penson and Wedbush have already been sharpening their arguments throughout the years Nasdaq has been amending its rule. In its approved version, Nasdaq requires broker-dealers who provide sponsored access to the exchange to apply pre- and post-trade financial and regulatory controls when doing so.

The SEC proposal expanded upon Nasdaq's rule. It would require broker-dealers to apply risk checks automatically on



Jeff Bell, Wedbush Securities

a pre-trade basis whenever it directly accesses any exchange or ATS--whether for the sponsored access or direct market access of a client's order.

The broker-dealer alone would manage these controls and could not entrust them to a customer or a third party. It also would require a broker-dealer to create a supervisory system to verify the controls' effectiveness in perpetuity.

The regulator said it would receive public comments for a 60-day period. Penson, for its part, has requested an exemption for large clearing firms that provide unfiltered sponsored access to registered broker-dealers.

Wedbush has said it should not be required to perform pre-trade risk checks for its broker-dealer clients because it already verifies that the clients perform them. The firm said it plans to write a letter to the SEC during the comment period, Bell said.

Other firms that provide unfiltered sponsored access may not put up as much of a fight as Penson and Wedbush. OES MarketGroup, a Newark, N.J.-based routing broker that provides 150 broker-dealer customers with access to market centers, already applies pre-trade risk checks to DMA orders. For sponsored-access orders, though, OES performs the checks only after they're entered and executed, said Mike Barth, executive vice president in charge of strategic investments.

"We'll have to integrate our hardware in between our customer and the exchange," he said, "as well as provide the necessary risk management tools and have all the different compliance applications that we need to have."



Dan Weingarten, Penson Financial Services

By one industry report, from Aite Group, roughly 38 percent of all equities volume flows to the exchanges through a naked access connection--meaning, without first passing through a sponsoring broker's system, and without any pre-trade risk checks. The report said that 50 percent of all volume goes through a sponsored-access arrangement.

Penson and Wedbush have said that providing a market participant identifier--or MPID--to non-broker-dealer customers for high-speed market access accounts for less than 5 percent of each firm's business. Both also contend that they don't add the systemic risks to the markets that "fat finger" errors or the breaching of credit thresholds could cause, by virtue of the fact that they clear for the firms they sponsor.

"At the end of the day, as the clearing firm, as the [National Securities Clearing Corporation] member, Penson has an obligation to clear those trades," said Dan Weingarten, who is co-director of global sales and marketing for Penson Financial Services and also president of Penson Execution Services. "So, we don't add any systemic risk to the process. The process of what Penson, as a clearing firm, has to do ensures that its clients are abiding by the rules of margins and leverage, that they correspond."

At Wedbush, its due diligence includes extensive background checks on clients and hands-on verification of clients' pre-trade risk controls, Bell said. Wedbush also reviews orders using an FTEN real-time risk management system throughout the day and at the end of the day.

The SEC proposal won't affect Bon Trade's business. Pre-trade risk checks have been part of the vendor's low-latency market connectivity technology for years, according to Vic Tartaglia, a managing director there. The firm supports the SEC's proposal.

"It's a good thing for the capital markets," Tartaglia said. "When it looked like it was only for sponsored access, the SEC took it an extra step. The proposed rules say you need to have it for all of your securities trading, even for your internal

transactions."

Customers come to clearing firms such as Wedbush and Penson to have their orders bundled together and sent to, say, Nasdaq in order to surpass the minimum volume requirements needed to take advantage of the exchange's top-tier liquidity rebate.

Applying an additional layer of pre-trade risk checks could hurt Wedbush's tiering business, Bell said. This is because high-speed trading firms could choose to instead obtain their broker-dealer license and reach the markets through their own MPIDs. Doing so would avoid the additional latency the extra risk check would add.

But Wedbush could gain that back on the clearing side, Bell added. Firms that clear through a large prime broker and previously counted on exchange tiering rebates might move to a Wedbush to save on their clearing costs.

For more information on related topics, visit the following channels:

- [Brokerage](#)

©2010 Traders Magazine and SourceMedia, Inc. All rights reserved.

SourceMedia is an Investcorp company.

Use, duplication, or sale of this service, or data contained herein, is strictly prohibited.