

Sec Ind News: Trading TradeOff: When To Monitor Sponsored Access 2009-07-20  
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By John Hintze

Wall Street heavyweight Goldman Sachs, now launching its own sponsored-access service to lend clients its identification to access securities exchanges directly, said last week it favors monitoring client orders prior to execution.

"Our view is that there is a real need for pre-trade checks in the use of sponsored access to fulfill [broker-dealers'] regulatory responsibilities," said Greg Tusar, managing director at Goldman.

Goldman's stand in favor of pre-trade instead of post-trade monitoring of sponsored clients' activity is one side of a debate in which regulators may choose a middle ground. The regulators' decision on how to monitor sponsored access may also influence their deliberations on restricting short sales.

Even though it publicly is taking a stance in favor of pre-trade monitoring-which can slow down the execution of trades in high-speed markets where milliseconds count-Goldman has yet to submit a comment letter on Nasdaq's January proposal to standardize sponsored-access arrangements. But Goldman says it has discussed the issue with regulators.

In sponsored access, a broker-dealer lends its market participation identification (MPID) number to clients for them to trade on exchanges without going through the broker's trading system, to avoid slowing down the execution. That places responsibility on the broker-dealer to make sure the participant abides by securities regulations, and that its trading, which can involve hundreds or thousands of orders a second, does not run amok.

Unchecked errors or unintended repeat orders could deplete broker-dealers' capital, and potentially wreak havoc in the broader market. Concerns have arisen, however, about whether all broker-dealers are able to fulfill that duty in today's electronic trading environment, and according to which standards.

"In the case of high-frequency trading, in particular guarding against technology failures, oversized orders and other situations where there's potentially systemic market impact, we believe strongly that pre-trade checks are a prerequisite," Tusar says.

In traditional sponsored-access arrangements, a broker-dealer determines a client's suitability to access market centers directly and then allows the client to trade without monitoring its individual orders prior to execution.

The arrangements have raised concerns about unregulated trading firms accessing market centers without the responsibilities and regulatory oversight applied to broker-dealers. Without those ongoing controls, those firms-especially high-frequency electronic ones-could intentionally or inadvertently execute thousands of problematic orders.

Lime Brokerage, which caters to broker-dealers and hedge funds, notes in a February comment letter that traditional sponsored access undermines proper oversight of markets and their participants, and provides "de facto" exchange membership to non-broker-dealers.

Lime submitted a second comment letter June 30 saying traditional sponsored access also makes compliance with rules such as Regulation SHO, governing short sales, practically impossible. That's because any monitoring would take place after the trade.

"Reg SHO is not a post-trade requirement but an order-placement requirement," says John Jacobs, director of operations of Lime and author of the comment letters.

Nasdaq's proposal as well as Securities and Exchange Commission officials' speeches a few months ago appeared to lean toward bolstering the traditional approach.

"We don't believe that's strong enough or what the regulators want now, because of the potentially dire consequences, and because we-as broker-dealers-bear much of that risk," Tusar says.

The mother of all concerns is a sponsored firm's algorithm going awry and executing thousands of problematic trades across a range of securities and market centers.

Lime notes in its June comment that computerized day-trading (CDT) order-placement rates often exceed a thousand orders per second. The firm contends that by the time a sponsor detects the problem and addresses it, at least two minutes will have passed, resulting in 120,000 orders going into the market.

At \$20 per share, that's \$2.4 billion of improper trades, which Lime calls highly disruptive to a fair and orderly market. It adds that what it calls "naked access" must be addressed or "the next 'Long Term Capital' meltdown will happen in a five-minute time period."

Goldman and Lime are each using software from New York-based FTEN to monitor sponsored clients' orders before they go to market. Goldman recently started offering sponsored-access to clients through its agency-only broker-dealer, Goldman Sachs Execution & Clearing L.P. (GSEC). Tusar says that GSEC is now getting its first few clients up and running and prior to using FTEN's software did not offer the service due to risk concerns.

FTEN, which has also submitted comment letters to the SEC in support of pre-trade monitoring, offers software to capture the exchanges' execution confirmations and enable clients to monitor trades post execution, in nearly real-time. Wedbush Morgan, one of the top providers of traditional sponsored access, uses that version of the software because its clients seek speed to execution, and a pre-trade risk filter is an additional hurdle to cross, costing a slice of time.

"A lot of this comes down to having the least latency to market, because the one there first wins," says John Goeller, head of electronic trading services at Bank of America Merrill Lynch.

Wedbush was one of the first broker-dealers to cater to high-frequency traders, clearing trades for powerhouses such as Tradebot, Getco and BATS Exchange.

Jeff Bell, executive vice president at Wedbush, agrees that algorithms running amok is a major concern, although Wedbush regularly scrutinizes its sponsored clients' systems and through FTEN receives and monitors exchange drop copies immediately after trades are executed.

He said Wedbush has seen just two significant trade-related errors over the last four years, and "both cases were caught immediately and very manageable."

Since its comment letter, Wedbush has developed an alternative plan to monitor sponsored-access trading that centralizes trade data at the National Securities Clearing Corp. settlement facility. It could resolve the concern about broker-dealers' ability to view clients' complete activity across market centers. (See story, page 21).

This remains a post-trade answer, however. Lime argues that broker-dealers can't comply with Regulation SHO using post-trade solutions.

"If you're running strategy across Nasdaq, BATS and NYSE, Reg SHO requires looking at net position [pre-trade] across your entire broker MPID," Jacobs says.

In addition, most clearing systems detect erroneous locates only if positions are held overnight, potentially leaving day traders free to pursue naked shorts as long as they settle the transactions by the end of the trading day.

Indeed, day traders may be the only market participants still engaged in naked shorting. Following the issuance of interim Rule 204T last October, requiring delivery of securities within four days after trade settlement, the exchanges' threshold lists of securities experiencing significant and lengthy short-sale delivery failures have shrunk dramatically.

Bell says Wedbush routinely tests clients' systems to ensure they are compliant with Reg SHO. In addition, he says, the brokerage sets limits on clients' available locates—as well as credit and trading limits—before the start of each trading day that its system tracks, prohibiting shorts without locates and providing a type of pre-trade check.

Goeller says he believes the SEC may arrive at a nuanced solution that prioritizes establishing a standardized and level playing field. "What we're lacking is standards. What does it mean when we say pre-trade checks. Which ones are required or optional," Goeller says.

Merrill Lynch's sponsored-access program has been running for just over a year. Goeller says the firm uses both FTEN's pre-trade and post-trade monitoring software, employing only the post-trade software typically for other broker-dealers, themselves regulated entities.

Goeller says the SEC's solution likely will combine both monitoring approaches, given that some sponsored participants will have their own advanced software to report those pre-trade checks to their broker-dealers. "There's probably going to be a flavor of that for the more sophisticated clients," he says.

As the SEC also seeks to appease investor concerns over rampant short selling, especially naked short selling, new sponsored-access standards may provide part of the solution. Given that day-traders may be the last remaining culprits of such activity,, increasing and standardizing scrutiny over their trading may reduce uncovered (and illegal) shorts even further.

Trading TradeOff:

When To Monitor Sponsored Access To Exchanges

Clients are using the IDs of broker-dealers to make thousands of trades a second, directly on stock exchanges. But should brokers monitor the activity before or after the trade? The arguments for each:

Pre-trade

- \* Compliant with Reg SHO
- \* Nip problems before they happen
- \* View activity across exchanges

Post-trade

- \* Faster order executions
- \* Pre-trade systems still fallible
- \* Ties risk management to stakeholders

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