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Crackdown on Unsupervised Stock Trades May Spur More Brokerages

By Nina Mehta

Jan. 14 (Bloomberg) -- The Securities and Exchange Commission's plan to ensure all orders sent to U.S. exchanges are subject to risk controls may prompt high-speed trading firms to convert into broker-dealers.

Commissioners voted yesterday to ban brokerages from giving clients unsupervised access to stock markets, a practice that Aite Group LLC says accounts for two of every five shares that change hands in the U.S. SEC Chairman Mary Schapiro said so-called naked sponsored access, in which customers bypass the controls of brokers and reach exchanges directly, may expose the market and firms that offer the service to too much risk.

Regulators would gain more control over high-frequency trading, or strategies that involve sending orders in as little as several hundred microseconds, should users of the practice apply for licenses to buy and sell directly on exchanges. The biggest trading firms will probably choose that route rather than suffer delays imposed by brokerages' risk checks, according to Jamie Selway of White Cap Trading LLC.

"If the SEC requires risk management checks and balances to reside at the broker-dealers, then proprietary trading firms will simply become broker-dealers," said Selway, a managing director at the New York-based trading firm and the former chief economist at Archipelago Holdings Inc., which NYSE Euronext bought in 2006. "It's a trend that's already started with the largest, most successful high-frequency firms."

SEC Registration

Getting a license would authorize the firms to buy and sell securities and require them to register with the SEC. Those that handle orders for customers must also be registered with the Financial Industry Regulatory Authority, which oversees almost 5,000 brokers.

Some of the biggest high-frequency firms already have brokerage licenses. Chicago-based Getco LLC, the largest, and Tradebot Systems Inc. of Kansas City, Missouri, are subject to legal, compliance and regulatory reporting requirements and examinations by their regulators.

Sponsored access represents about half of U.S. equities trading, with naked access accounting for 38 percent, Aite Group, a financial services research firm in Boston, said in a December report. The SEC has been under pressure from Senator Ted Kaufman of Delaware, a Democrat, to address concerns that high-frequency firms could disrupt the market with trading that isn't monitored beforehand.

SEC commissioners are formulating the next round of stock market regulation, focusing on the impact of high-frequency strategies used by professional investors. The agency voted 5-0 to approve the market-access proposal yesterday.

'Financially Vulnerable'

"We are concerned that order-entry errors in this setting could suddenly and significantly make a broker-dealer or other market participants financially vulnerable within mere minutes or seconds," Schapiro said at a hearing in Washington yesterday.

Accidental orders and those that don't comply with regulations could enter the market, jeopardizing the firm getting sponsored access or its executing and clearing brokers, according to Schapiro. Sponsored access refers to arrangements where a broker gives customers its identification number so they can trade on exchanges or other venues.

In addition to the potential for bad trades, naked sponsored access may allow deliberate fraud and illegal trading such as improper short selling to go undetected, according to the SEC.

Higher Costs

"Such 'unfiltered' arrangements occur mainly to give a customer -- often a high-frequency trader -- a fraction-of-a-second advantage in the high-speed transactional world that exists today," Schapiro said.

Complying with the new regulatory regime by becoming brokerages may boost costs for high-frequency traders, who seek to profit from fleeting price discrepancies in markets.

"Hopefully this wouldn't increase the cost of liquidity in the marketplace or raise the bar too high for new entrants," Selway said.

High-frequency firms use naked access to trade faster by avoiding pre-trade risk controls, giving them an advantage over broker-dealers engaged in similar strategies who must police themselves, according to **Joe Saluzzi**, a partner at **Themis Trading** LLC in New York and a critic of high-frequency trading.

Should they become brokerages themselves, they may lose that advantage and face tougher competition, he added.

"They can go away or become a broker-dealer if they want to try to remain competitive with the larger brokers," he said.