Woodbine *Opinion*

Views on Issues Impacting the Capital Markets by the Analysts of Woodbine Associates

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The SEC Risk Management Proposal – A Fair Start but Lacking Specifics

Kudos to the Securities and Exchange Commission (SEC) for proposing Rule 15c3-5 under the Securities and Exchange Act of 1934 entitled "Risk Management for Brokers or Dealers with Market Access." The proposed rule focuses on brokers and dealers that trade directly on an exchange, ECN, or ATS, or provide that access to clients. It is intended to ensure that appropriate risk controls and supervisory procedures are in place to manage financial, regulatory, operational, and legal risks associated with trading activities. The rule encompasses trading in equities, options, bonds, and futures.

The proposed rule makes special mention of the need for broker controls and procedures around orders from clients that enjoy "naked access." Often engaged in high frequency trading, these firms route orders through a broker that are not subject to risk controls and trade under the broker's MPID. The obvious concern is that this practice places sponsoring brokers at considerable financial and legal risk.

Proposed pre-trade controls that check orders for anomalous values, share quantities, or check the number of orders relative to historical trends make good sense except in the case of certain high frequency strategies. Leaving discretion to brokers to establish baseline controls and procedures is not such a good idea as it ensures inconsistency across brokers and subjectivity during SEC examinations.

Pre-trade operational controls and procedures implemented to reduce the risk of release of erroneous orders makes sense in the type of scenarios illustrated in the proposal. The SEC cites examples where "fat fingers" were or thought to have been the cause of erroneous orders released to market that resulted in financial loss, broken trades, declines in stock value, and general operational chaos. Reference is made to a September 2008 event in which erroneous orders in Google stock resulted in a decline in stock value approaching 93% at one point, broken trades, and the need to recalculate the closing value for the Nasdaq 100 Index. Also noted is a December 2005 event in which Mizuho Securities mistakenly entered a sell order on the Tokyo Stock Exchange for 1 share of J-Com Co at ¥ 610,000 as a sale of 610,000 shares at ¥ 1, resulting in a $225 million loss. We suspect that these instances were situations that involved a simple inversion or multiple of intended numbers pertaining to intended values during order entry that *might or might not* have been prevented with the controls designed to detect unusual variances in order quantities, sizes, or limit price with respect to prevailing price of the security.

Controls and procedures around the activities of algorithmic or HFT firms with naked access pose a set of challenges that are not solved by basic controls advocated in the proposal. Algorithmic trading and HFT strategies often involve a large number of orders and may commonly result in large directional positions. Differentiation between intended and erroneous orders might not be as easily detected by basic pre-trade controls. This shortcoming is amplified by the consideration that the broker implementing the controls is often not privy to the details of the strategy.

Leaving brokers to establish baseline risk controls and procedures for naked access clients almost certainly ensures minimal and inadequate risk management. Intense competition among brokers for high volume trading clients, combined with the reluctance of HFT firms to reveal their strategies, almost guarantees that brokers will compete amongst each other by offering HFT firms the least intrusive risk analyses and fewest controls.

We believe that a clearly defined, explicit set of baseline operational risk controls and procedures mandated by the SEC and applied uniformly across brokers providing sponsored access would provide better protection to the broker community and to overall market operations. A mandated set of uniform baseline controls would eliminate competitive pressures on brokers to pare risk management practices as a means of attracting clients and ensure a standardized set of controls applied across sponsored access providers.

In our opinion, a preferable way to control systemic risk would be to mandate a reduction in permissible leverage or an increase in risk capital for users of sponsored access along with uniform operational risk controls at brokers providing sponsored access. These requirements would reduce the ability of sponsored access clients to incur large positions and, to a degree, enhance broker abilities to catch egregious errors among orders. A change in leverage or required risk capital among sponsored access clients would make these arrangements more expensive, potentially resulting in the migration of algorithmic and HFT strategies to other geographic markets or to other businesses altogether where the perceived returns become relatively more attractive.

The problem with the leverage/capital approach discussed above is that it cannot be implemented in the current markets since the SEC does not have regulatory authority over hedge funds, the primary users of sponsored access. That said, the best available (and probably the only practical) alternative is uniformly implemented operational risk controls of the type discussed in the SEC proposal, *provided that* the controls are clearly specified and uniformly applied across brokers offering sponsored access.

There has been talk in the industry that eliminating naked access would simply result in users of that service (notably HFT firms) to establish themselves as brokers. This would be preferable from the standpoint of systemic risk control since, as brokers, these firms would become subject to regulatory oversight.

In summary, the SEC risk management proposal is a favorable initial step (and probably the only feasible practical step) toward systemic risk control. However, it stops short. To be effective, baseline operational risk controls and procedures must be explicitly stated and uniformly applied to all brokers. If systemic risk control is a true regulatory priority, it will require all market participants to be subject to regulation and this will require a legislative change in regulations that permits regulation of hedge funds.

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