SEC Aims to Ban 'Naked Access'

Critics See Liquidity Hit, but Agency Cites Market Stability in Pushing Move

By SCOTT PATTERSON

The SEC proposed to ban a trading arrangement known as "naked access," in a move that could set back the fast-growing high-frequency trading industry.

Naked access allows high-speed traders and others to rapidly buy and sell stocks directly on exchanges using a broker's computer code without exchanges or regulators always knowing who is making the trades. The practice is akin to members of an exclusive club charging others to use their pass.

The Securities and Exchange Commission fears that a firm trading anonymously this way could trigger destabilizing losses and threaten market stability if their rapid-fire trades go awry, chairman Mary Schapiro said Wednesday.

The proposed ban would require "that if a broker-dealer is going to loan his keys [to a naked-access trader], he not only must remain in the car, but he must also see to it that the person driving observes the rules before the car is ever put into drive," Ms. Schapiro said in a meeting on the new proposal.

Defenders of naked access say the rapid trading it enables provides liquidity to markets. They say high-speed trading firms are sophisticated and have risk-management tools that limit the likelihood of destabilizing trades.

In addition to high-frequency firms that use naked access, many market players have a stake in the outcome of the proposal. They include exchanges that make money from naked-access trading volume, brokers that provide naked access to traders, and the proprietary-trading operations of some large banks that could have a competitive advantage if naked access is banned.

In the race for speed, a rising number of high-speed traders in recent years have used naked access to gain an edge over competitors. Naked access accounts for 38% of market volume, up from 9% in 2005, according to Aite Group, a Boston research group that tracks electronic trading.

The rule proposed Wednesday would require brokers that permit access via their codes to subject clients to pretrade checks. That means traders who aren't registered brokers would need to funnel market orders through the broker's computer systems before the orders go to the exchange—an arrangement known as sponsored access. For now, naked-access orders are largely subject to checks that occur after
the trades have been executed.

Since the trades are sent without pretrade checks, they reach the market faster than trades filtered through a broker's system.

A firm that uses naked access can execute a trade in 250 to 350 microseconds, compared with 550 to 750 microseconds for trades that travel through a broker's computer system by sponsored access, according to Aite's report. A microsecond is one-millionth of a second.

In the computer-driven world of high-frequency trading, the 300 to 400 microsecond gap can mean the difference between winning and losing.

Experts say few traders who currently use naked access will agree to filter their trades through a broker. Instead, they will apply with regulators to become brokers themselves.

That could lead to unintended consequences, some say. "If [the SEC] takes away that level of access, they've created a lot more barriers to entry for firms trying to get into the space," said Jeff Bell, executive vice president of the clearing and technology group at Wedbush Securities, a Los Angeles firm that provides clients naked-access services.

That could make it harder for new firms get a foothold in the high-frequency trading industry. It also could lead to more consolidation among high-frequency firms, which could share the expenses of becoming a registered broker, he said.

Some fear a ban on naked access could make high-frequency trading even more risky. Trading firms that currently use a broker's computer code are subject to the broker's risk-management oversight, even if the trades aren't funneled directly through the broker's systems.

High-frequency trading firms that become brokers would effectively trade the oversight of a broker with government oversight.

That is a poor trade, says Larry Tabb, chief executive of financial-services consulting firm Tabb Group. Brokers have an incentive to ensure that firms they sponsor trade safely, because they can be on the hook for big losses incurred by the firm.

"The issue becomes in effect nobody is looking over their shoulder" in real time, he said.

The SEC is soliciting industry and public comments on the proposal.

The move isn't the first action taken by the SEC toward reining in high-frequency trading practices. Last year, the SEC proposed a ban on so-called flash trading, which gave some market participants a sneak peek at market order flow.

Separately, on Wednesday, exchange operator NYSE Euronext fined a unit of Credit Suisse Group AG $150,000, saying that the firm violated trading rules in November 2007 when one of its algorithms mistakenly routed "hundreds of thousands" of cancel/replace requests for orders that had never been sent in the first place, causing a jam that slowed other trades.

—Jacob Bunge
contributed to this article.