Commentary: The Changing Role of the Broker-Dealer in an Electronic Universe

By Stephen J Nelson; The Nelson Law Firm, LLC

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Last Wednesday, the SEC proposed rules on sponsored access, or to use the phrase coined by the SEC in its press release on the subject, "naked access." The new rules, if adopted, would require a broker-dealer that allows its customers to use the broker-dealer's exchange trading privileges to put in place controls and procedures to "prevent erroneous orders, ensure compliance with regulatory requirements, and enforce pre-set credit or capital thresholds."

Controls and procedures are, of course, a good thing. The process of designing and implementing procedures forces firms to think about legal and regulatory compliance. On the dark side, a requirement to institute procedures sets up a sort of double whammy: if a firm is found to have violated a legal or regulatory requirement, obviously the firm's procedures are inadequate, which instantly transforms one regulatory violation into two, justifying greater penalties.

The difficulty with the proposed prohibition on "naked access" is that there are no cases that I am aware of where customers that traded using a firm's identity submitted erroneous orders, failed to comply with regulatory requirements or breached any pre-set credit or capital thresholds, at least in any way that was particularly unusual or frightening. Errors in trading do happen from time to time, and errors are even made by broker-dealers with all sorts of elaborate controls to prevent them. But, one would have thought that with all of the market volatility we have witnessed over the last two years, the SEC would have been able to point to striking examples of erroneous errors, non-compliance with regulatory requirements and breaches in capital requirements attributable to sponsored access that cried out for the proposed regulation. In short, the proposed rules appear to provide a remedy where there is no disease.

The proposal seems to target high-frequency traders, who have been vilified lately in the financial press and attracted the attention of Congress. But, the rule does not prohibit high-frequency trading. At most, the rule will increase the costs of sponsoring high-frequency trading. To the extent those costs are passed along, high-frequency trading will be a less profitable enterprise. If the goal is to slow markets down, this rule is unlikely to succeed and seems an odd way to go about it.

The real question is whether the broker-dealers who provide sponsored access are performing any useful function for which they should receive payment. If the middle man isn't doing anything, why are we paying him?

Sponsored access, as well as high-frequency trading, were consequences of Regulation NMS. Perhaps the SEC did not anticipate just how successful a business sponsored access would be, or how fast markets would become, but these were hardly "unintended consequences." Regulation NMS contemplated that NYSE member firms would provide sponsored access to non-members, and its entire purpose was to transform slow, floor-based exchanges, like the NYSE, into fast, electronic marketplaces.

Nonetheless, the development of sponsored access calls into question the role performed by a broker-dealer in a world of electronic exchanges.

The terms "broker" and "dealer," as they are defined in the Securities and Exchange Act of 1934, are inextricably linked with the "National Securities Exchange," another Exchange Act term. Brokers and dealers were required to become members of a self-regulatory organization, and when the Exchange Act was adopted, that meant a National Securities Exchange.

Later, Congress ordered the SEC to create a "National Securities Association" with a view to gathering up all the over-the-counter broker-dealers that weren't members of an exchange into a self-regulatory organization. This legislation resulted in the institution of the National Association of Securities Dealers, Inc. (NASD). The NASD went on to create NASDAQ, in the beginning just an electronic bulletin board for its members to post quotes.

The point is that broker-dealers, as conceived by the Exchange Act, had privileged access to stock markets. This was the bargain struck in exchange for submitting to, and paying for, self-regulation. This regulatory apparatus reflected the technology of the day. In the pre-electronic era, trades required physical interaction among buyers and sellers. Since there is a limit to how many traders can assemble in any one place, the physical dimensions of exchange floors meant that access to the floor was necessarily privileged.

In the early 1990s, Instinet fractured this commercial and regulatory structure, and all the King's horses and all the King's men have not been able to put it together again.

Instinet performed all the functions of an exchange. It gathered together buyers and sellers of securities to execute trades. But, it was not registered as an exchange. Instead, Instinet was permitted to register as a broker-dealer, which made the buyers and sellers that used its facilities its customers. As a practical matter, Instinet was unable to comply with many of the capital and other requirements imposed on broker-dealers. But, the SEC perceived Instinet as a promising market innovation and granted it a slew of regulatory exemptions that permitted it to operate.

Instinet's categorization as a broker-dealer allowed institutional investors that were not broker-dealers to use its facilities to trade with each other. Since the exchange operated by Instinet was electronic, there was no technological limit on the number of persons who could use its facilities to execute trades. Finally, Instinet had no regulatory function, which allowed it to offer its services at lower rates than exchanges.

But, Instinet also revealed another horrifying reality. Institutions do not require the actual services of broker-dealers to execute trades in an electronic marketplace. The only reason broker-dealers still are strictly necessary to the institutional business is the that the law continues to require that trades be made on exchanges and that trades on exchanges be executed by broker-dealers.

Since the advent of Regulation NMS, the national securities exchanges resemble Instinet more than the traditional floor-based exchanges contemplated by the Exchange Act. There is nothing left of the old exchange floors, which now serve as a little more than fancy public relations backdrops. The regulation of broker-dealers, in the meantime, has been delegated for all practical intents and purposes to FINRA, formed from the union of NASD Regulation and NYSE Regulation. Exchange regulation is limited to market regulation, a function that even Instinet had to perform to keep trading orderly.

Nevertheless, the Exchange Act still decrees that only broker-dealers can trade on exchanges. Certainly, retail customers still need the services of broker-dealers and, even in the institutional world, many institutions prefer using broker-dealers to preserve their anonymity in the marketplace. However, it is time to re-think the Exchange Act framework in the context of the modern, electronic markets.

The SEC can't do this on its own—the Exchange Act's statutory underpinnings can't be changed without Congressional action. Meanwhile, I guess the SEC will just have to keep coming up with more busy work for broker-dealers to perform to justify their fees.

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