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SEC Adopts Final Rule Regarding Risk Management Controls for Broker-Dealers with Market Access

On November 3, 2010, the Securities and Exchange Commission (the "SEC") voted unanimously to adopt a new rule that will effectively prohibit broker-dealers with market access from providing customers with unfiltered access to an exchange or alternative trading system ("ATS"). Rule 15c3-5 (the "Rule") will require broker-dealers with direct market access to trading securities on an exchange or ATS to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, are reasonably designed to (1) systematically limit the financial exposure of broker-dealers that could arise as a result of market access, and (2) ensure compliance with all regulatory requirements that are applicable in connection with market access.[1] It encompasses trading in all securities on an exchange or ATS, including equities, options, exchange-traded funds, and debt securities, and is intended to strengthen the controls with respect to market access and reduce regulatory inconsistency and the potential for regulatory arbitrage. The Rule was adopted with only minor changes to the proposed rule that was published for comment in January 2010, and becomes effective 60 days from the date of publication in the Federal Register.

Background

Broker-dealers with direct market access to an exchange or ATS use a market participant identifier ("MPID") when effecting trades, and are legally responsible for any trades made using their MPID. Allowing third parties to trade using a broker-dealer's MPID could result in the broker-dealer paying lower transaction fees based on a volume discount. A broker-dealer also may network with another broker-dealer to gain access to an exchange where it is not a member. For customers, such as hedge funds and institutional investors, trading using a broker-dealer's MPID may facilitate more rapid trading, preserve confidentiality of trading strategies, and reduce operation and transaction costs. Broker-dealers provide customers with sponsored access to their member exchanges or ATSs either through filtered or unfiltered access arrangements.

When a broker-dealer provides filtered access to customers, the customer orders flow through the broker-dealer's system before passing into the markets. The system allows a broker-dealer to pre-screen a trade to ensure there are no manual errors, regulatory violations, or other issues prior to passing it on to the exchange or ATS. Filtered access is currently regulated by the exchanges and self-regulatory organizations; however, the regulations are not uniform, and in some instances, the rules serve merely as best practice guidelines.

Unfiltered access arrangements, on the other hand, enable customers to directly execute trades on an exchange or ATS by using the broker-dealer's MPID. The customers, since they are not registered broker-dealers, do not have to comply with federal securities laws or self-regulatory organization requirements. Unfiltered access to markets

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[1] Available at http://www.sec.gov/rules/final/2010/34-63241.pdf (last viewed on November 4, 2010).

can result in erroneous orders and impede a broker-dealer's ability to comply with pre-order regulatory requirements. The SEC adopted the Rule in an attempt to reduce trade errors and eliminate unregulated access to exchanges and ATSs through unfiltered access arrangements, which could cripple the trading market and increase systemic risk in the financial markets.

The Rule

The Rule requires any broker-dealer who offers market access to its customers to establish controls and procedures reasonably designed to prevent:

- the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer (and reject orders if such orders exceed the applicable credit or capital thresholds);[2]

- the entry of erroneous orders;[3]

- the entry of orders that are not in compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;[4] and

- the entry of orders for securities that the broker-dealer, customer, or other person, as applicable, is restricted from trading.[5]

Based on comments received after publication of the proposed rule, the SEC added a limited exemption to the Rule with respect to three of the four requirements above. Recognizing that exchanges and ATSs use outbound order routing services provided by broker-dealers to comply with trade-through provisions of other SEC and market regulations, the SEC exempts broker-dealers who provide outbound routing services to an exchange or ATS for the sole purpose of accessing other trading centers with protected quotations on behalf of the exchange or ATS from complying with the Rule's requirements except for those related to preventing the entry of erroneous orders. The exemption is further limited to include services performed by routing broker-dealers for the purpose of complying with trade-through provisions of SEC and market regulations and not direct routing services performed for exchange or ATS customers. The requirement that outbound routing broker-dealers maintain controls reasonably designed to prevent the entry of erroneous or duplicative orders should help ensure that order handling by exchange or ATS routing broker-dealers does not increase market risk.

In addition, broker-dealers' controls and procedures must be reasonably designed to restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by broker-dealers. The controls and procedures should include:

- developing an effective process for vetting and approving persons at the broker-dealer or customer, as applicable, who will be permitted to use the trading systems or other technology;

- maintaining such trading systems or technology in a physically secure manner; and

- restricting access to such trading systems or technology through effective passwords or other mechanisms that validate identity.[6]

Finally, the Rule requires that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access that contain information about financial exposure faced by broker-dealers at a

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[2] Rule 15c3-5(c)(1)(i).
[3] Rule 15c3-5(c)(1)(ii).
[4] Rule 15c3-5(c)(2)(i).
[5] Rule 15c35(c)(2)(ii).
[6] Rule 15c3-5(c)(2)(iii).

given point in time, potential regulatory violations, and any other information that will better enable them to investigate, report, or halt suspicious or manipulative trading activity.[7]

Proposed rule 15c3-5(d) would have required the financial and regulatory risk management controls and supervisory procedures to be under the direct and exclusive control of the broker-dealer and should be monitored in real time. As a result of comments provided to the SEC after the proposed rule was released, the Rule was revised to permit a reasonable allocation of control over a regulatory risk management control or supervisory procedure to another registered broker-dealer if such broker-dealer is better positioned to implement it than the broker-dealer providing market access. The allocation approach is similar to the approach under New York Stock Exchange and the NASDAQ rules. In order to allocate control, the broker-dealer providing market access must be able to demonstrate a reasonable basis for determining that the broker-dealer customer, based on its position in the transaction and relationship with the ultimate customer, has better access to the customer and trading information to more effectively implement the specific function over which control is allocated.

For a broker-dealer providing market access to meet the "reasonable basis" standard when allocating control over a specified function to a broker-dealer customer, the SEC expects the broker-dealer to (i) conduct a thorough due diligence review to establish that the broker-dealer customer, based on its position in the transaction and relationship with the ultimate customer, has better access to the customer and trading information to more effectively implement the specific function over which control is allocated; (ii) enter into a written contract with the broker-dealer customer that clearly sets forth the scope of the arrangement and the specific responsibilities of each party; and (iii) establish, document, and maintain a system to regularly review the performance of the broker-dealer customer under such contract and the effectiveness of the allocation of control, and promptly address any performance weaknesses.

Despite the SEC's willingness to revise the proposed rule to incorporate the allocation model discussed above, the SEC did not revise the portion of proposed rule 15c3-5(d) with respect to third party providers of risk management technology. The Rule requires broker-dealers using risk management tools or technology provided by a third party that is independent of the customer to have direct and exclusive control over those tools or technology and perform appropriate due diligence on such third party to demonstrate the third party's independence.

In addition to the above, broker-dealers will be required to review, no less frequently than annually, their business activity in connection with market access to assure the overall effectiveness of such risk management controls and supervisory procedures and document the results of such each review.[8] Also, the Chief Executive Officer (or equivalent officer) of the broker-dealer will be required, on an annual basis, to certify that such risk management controls and supervisory procedures comply with the proposed rule and that the broker-dealer conducted the regular review. The broker-dealer will be required to preserve a copy of such written procedures, documentation of each such review, and the annual officer certifications as part of its books and records in a manner consistent with Rules 17a-4(e)(7) and 17a-4(b) under the Securities Exchange Act of 1934, as amended. These provisions were adopted as set forth in the proposed rule.

Types of Controls and Procedures Needed

In its release adopting the Rule, the SEC made clear that the use of "reasonable" standards language throughout the Rule was meant to provide flexibility to address different broker-dealer roles and trading activities and that the SEC did not believe that a "one size fits all" approach was warranted. Therefore, in response to commenter questions, the SEC set forth various examples of how broker-dealers could meet the requirements under the Rule. When establishing controls and procedures reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds for each customer, broker-dealers should conduct appropriate due

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[7] Rule 15c3-5(c)(2)(iv).
[8] Rule 15c3-5(e).

diligence to determine limits based on the customer's business, financial condition, trading patterns, and other matters, and adequately document that decision. Broker-dealers should also consider establishing "early warning" credit or capital thresholds to alert them and their customers when the firm limits are being approached, so there is an opportunity to adjust trading behavior. Broker-dealers should establish controls and procedures to prevent the entry of erroneous orders by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders. Pre-trade, system-driven controls should prevent orders from being sent to the securities markets if such orders fail to meet certain conditions. The pre-trade controls must, for example, be reasonably designed to assure compliance with exchange trading rules relating to special order types, trading halts, odd-lot orders, SEC rules under Regulation SHO and Regulation NMS, as well as applicable margin requirements. In addition, if broker-dealers are obligated to restrict customers from trading in particular securities, then the broker-dealers' controls must automatically prevent orders in such securities from being submitted to an exchange or ATS for the accounts of these customers.

Scope of Rule

Although the language of the Rule is mostly unchanged from the proposed rule, its scope was effectively changed due to revisions to the Rule's definition of "market access" under section 15c3-5(a)(1). In the proposed rule, "market access" did not include non-broker-dealer market participants, including non-broker-dealer ATS subscribers, and was further limited by the phrase "as a result of being a member or subscriber of the exchange or ATS, respectively," which excluded broker-dealers that operated an ATS and provided non-broker-dealer market participants with access to an ATS. Unlike exchanges, ATSs do not require that their subscribers be registered broker-dealers; therefore, the "market access" definition would have excluded non-broker-dealer ATS subscriber access from the scope of the proposed rule. The Rule revised the proposed rule's "market access" definition to include "access to trading in securities on an alternative trading system provided by a broker-dealer operator of an alternative trading system to a non-broker-dealer" to ensure that broker-dealer operators of an ATS are subject to the same requirements when providing ATS access to non-broker-dealer subscribers.

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