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SEC Adopts Rule Requiring Risk Management Controls for Market Access

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I. Introduction

On November 3, 2010, the SEC adopted the final version of Rule 15c3-5 (the “Rule”) under the Securities Exchange Act of 1934 (“Exchange Act”),¹ which will impose a series of risk management controls and supervisory procedures on brokers and dealers that have access to trading securities directly on an exchange or an alternative trading system (“ATS”), that provide such access to customers via sponsored access² or direct market access³ arrangements, or that operate an ATS and provide non-broker-dealers access to the ATS for trading securities.

In general, the Rule requires broker-dealers with market access, or that allow a customer or any other person to trade on an exchange or ATS through use of its market participant identifier (“MPID”), to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks (*e.g.*, legal and operational risks) related to their market access business activity.⁴ The Rule also requires broker-dealers to maintain direct and exclusive control over these controls and procedures,

subject to a narrow exception for allocation to customers that are registered broker-dealers, as well as preserve documentation and perform a regular review of their market access controls and procedures.⁵

In adopting the Rule, the SEC indicated that it was intended to address the increase in financial and regulatory risks due to the proliferation of automated, algorithmic, high-speed trading and the growth in customers, especially sophisticated institutions, placing orders under the MPID of their broker-dealer with little to no substantive intermediation by the broker-dealer via sponsored, direct market and naked access arrangements. According to the SEC, these market access arrangements, particularly naked access, in which the customer’s order is submitted to a trading center without the application of any pre-trade controls by the broker-dealer, can pose great risks to the market. These potential risks include, among other things, instances where capital or credit limits are exceeded, incorrect orders due to technological malfunctions or manual errors, noncompliance with SEC or exchange trading rules, and undetected misconduct. The Rule was adopted to address these risks by requiring orders to be filtered through pre-trade controls and procedures implemented by the broker-dealer

with market access.

The Rule could have a substantial impact on both the broker-dealers that provide market access and the customers who utilize such arrangements. Broker-dealers that offer sponsored and direct market access arrangements will have to review and possibly revise these arrangements and their market access controls to ensure they comply with the Rule. Further, investors, particularly sophisticated institutional investors, should inquire whether their current market access arrangement will need to be modified and possibly consider alternatives.

The Rule becomes effective on January 14, 2011, and compliance is mandated by July 14, 2011. This article provides a summary of the Rule and the impact it could have on market participants that offer and use market access.

II. Rule 15c3-5 Definitions

“Market Access”

In order to understand and comply with the scope of the Rule, it is important to understand the meaning of the terms “market access” and “regulatory requirements.” The term “market access,” which is crucial to understand because it determines which broker-dealers are subject to the Rule, was deliberately defined broadly by the SEC. The term includes broker-dealers that are members of

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an exchange or subscribers to an ATS as well as broker-dealer operators of ATSs that provide access to trading in securities on the ATS by non-broker-dealer subscribers.⁶ Requiring the ATS operator to implement the Rule's controls and procedures with respect to non-broker-dealer subscribers ensures that all orders entered on an ATS are subject to the Rule.⁷

The term "market access" also includes all securities traded on an exchange or ATS, such as equities, options, exchange-traded funds, debt securities, and security-based swaps if they begin being traded on a national securities exchange.⁸ Finally, while the term "market access" covers sponsored and direct market access by customers, it also includes more traditional agency brokerage activities and proprietary trading by broker-dealers. However, in the Final Release, the SEC specifically stated that it believes, in many cases, it is likely that the existing risk management controls and supervisory procedures related to proprietary trading and traditional agency brokerage arrangements currently employed by broker-dealers should substantially satisfy the requirements under the Rule.

"Regulatory Requirements"

The term "regulatory requirements," which is important because the Rule mandates that broker-dealers design controls and procedures to ensure compliance with such requirements, encompasses all federal and self-regulatory organization ("SRO") laws, rules, and regulations related to market access.⁹ The term "regulatory requirements" refers to existing regulatory requirements, including exchange rules related to special order types, trading halts, odd-lot orders, and non-member sponsored participant arrangements, SEC rules pursuant to Regulations SHO and NMS, and

post-trade responsibilities to monitor manipulation and other illegal activity. Over time, as laws, rules, and regulations are modified or new ones are adopted, the SEC acknowledges that the specific content that falls within the definition of "regulatory requirements" will change.

III. Risk Management Controls and Supervisory Procedures

The central focus of the Rule is the obligation for broker-dealers with market access to establish, document, maintain, and preserve documentation of risk management controls and supervisory procedures reasonably designed to manage financial, regulatory, and other market access risks.¹⁰ The Rule provides a limited exception for broker-dealers that 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 in order to comply with Rule 611 of Regulation NMS for NMS stocks or with a national market system plan for listed options.¹¹ The Rule provides this limited exception because, according to the Final Release, the orders provided to routing brokers will have already been subject to the Rule's risk management controls required of the broker-dealer of the MPID that placed the order.¹² These routing brokers, however, will still be responsible for meeting the provision of the Rule that requires 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 that indicate duplicative orders.

It is important to note that the SEC recognizes that the Rule does not impose a "one-size-fits-all" standard for compliance with the controls and procedures. To that end, the SEC stated that the standard for the controls and procedures is flexible, and each broker-dealer's controls or procedures may vary based on the broker-dealer's business and customer

types.¹³ The baseline requirement is that the controls and procedures be "reasonably designed" to meet the goals set forth in the Rule.

Furthermore, broker-dealers may utilize pre-trade risk controls offered by exchanges and ATSs in the broker-dealers' efforts to comply with the requirements of the Rule. For example, broker-dealers may utilize the market access tools provided by exchanges that allow members to apply filters to orders placed under the broker-dealer's MPID. Further, broker-dealers may apply the order entry controls offered by ATSs that allow subscribers to establish limits and prevent orders outside of such limits. The broker-dealer remains ultimately responsible, however, for implementing the required risk controls under the Rule.

IV. Financial Risk Management Controls and Supervisory Procedures

Paragraph (c)(1) of the Rule describes the financial risk management controls and supervisory procedures imposed by the Rule on broker-dealers with market access. These financial risk management controls and supervisory procedures must be reasonably designed to systematically limit the broker-dealer's financial exposure that could arise as a result of market access.¹⁴ The Rule specifically prescribes, among other things, two such limitations:

- The first limitation requires a broker-dealer to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker-dealer, and where appropriate more finely-tuned by sector, security, or otherwise, by rejecting orders if such orders would exceed the applicable credit or capital thresholds.¹⁵
- The second limitation requires a broker-dealer 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.¹⁶

Concerning the financial controls, broker-dealers:

- Must implement the controls on an automated, pre-trade basis before orders are routed to the exchange or ATS;
- May want to establish “early warning” systems to send out notifications as the applicable credit or capital threshold is being approached;
- May set smaller credit limits for each customer at each exchange or ATS that, when combined, total the established aggregate limit for that customer;¹⁷
- Should measure compliance with the appropriate credit and capital thresholds on the basis of orders entered rather than executions obtained;¹⁸ and
- Should reasonably design the controls related to price and size parameters to detect malfunctions and prevent erroneous orders that result from technological malfunctions and manual errors on an order-by-order basis or over a short period of time.

The Rule intentionally allows the broker-dealer to have flexibility in implementing these financial controls, in order to ensure the controls support the broker-dealer’s business. To that end, a broker-dealer should review its business and customer types to determine if more specific credit or capital limits are needed by sector, security, or otherwise. Broker-dealers should also consider the customer’s business, financial condition, trading patterns, and other relevant matters when establishing the credit and capital thresholds, should document the process, and should regularly review and update, as necessary, both limits. When deciding how to set parameters to prevent erroneous and duplicative orders, broker-dealers should consider the customer’s type, trading patterns, and order entry history. As an example of such a parameter, a broker-dealer could implement a systematic control that

only allows orders to be entered if the order is reasonably related to the security’s price quote.

The financial risk management controls and supervisory procedures delineated in the Rule are not inclusive, but merely a minimum standard. Broker-dealers may consider implementing financial controls and procedures in addition to those prescribed in the Rule.

V. Regulatory Risk Management Controls and Supervisory Procedures

Paragraph (c)(2) of the Rule describes the regulatory risk management controls and supervisory procedures that broker-dealers with market access must implement. Specifically, the Rule stipulates that the regulatory controls and procedures must be reasonably designed to: (i) prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; (ii) prevent the entry of orders for securities for a broker or dealer, customer, or other person if such person is restricted from trading those securities; (iii) restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer; and (iv) assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.¹⁹

The regulatory risk controls and procedures that are intended to prevent orders that do not comply with the regulatory requirements must be implemented automatically and before orders are entered. The SEC clarified, however, that only those regulatory requirements with which a broker-dealer can effectively comply before an order is entered on an exchange or ATS must be satisfied on a pre-trade basis.²⁰ For example, the regulatory requirements that must be satisfied on an order-by-order pre-trade basis include the Regulation SHO

marking and locate requirements, the Regulation NMS conditions that must be satisfied before marking an order as an “intermarket sweep order,” and exchange rules that govern special order types and trading halts. Further, if a customer, another person, or the broker-dealer is restricted from trading in certain securities, the broker-dealer must implement automatic, pre-trade controls to prevent the customer, person, or broker-dealer from entering an order for such securities. Other regulatory requirements, such as monitoring for fraud and manipulation, can be satisfied on a post-trade basis.

With respect to providing only pre-approved persons and accounts with market access, the SEC indicated that effective controls and procedures should include: (1) 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; (2) maintaining such trading systems or technology in a physically secure manner; and (3) restricting access to such trading systems or technology through effective mechanisms that validate identity.²¹

The Rule requires that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access. In this regard, broker-dealers are expected to, among other things, be able to identify the applicable customer associated with each execution report. Also, while appropriate surveillance personnel must receive the post-trade execution reports immediately, the Rule does not require all post-trade surveillances, such as those for manipulation and fraud, to occur immediately. Instead, these surveillances need only occur in a timely manner, as determined by the facts and circumstances.

RISK MANAGEMENT CONTROLS*(Continued from page 3)***VI. Broker-Dealer's Direct and Exclusive Control**

Broker-dealers, subject to a limited exception described in greater detail below, are required to retain direct and exclusive control over the financial and regulatory risk management controls and supervisory procedures mandated by the Rule.²² In other words, in general, broker-dealers may not rely on customers or a third party to establish or maintain the risk controls and supervisory procedures required by the Rule or delegate the oversight of such controls.

The one, narrow exception to the requirement of direct and exclusive control allows broker-dealers providing market access to reasonably allocate, subject to certain conditions, responsibilities related to the implementation of regulatory risk management controls and supervisory procedures to broker-dealer customers who, due to their position in the transaction and relationship with an ultimate customer, are able to more effectively implement the controls and procedures (e.g., a clearing firm allocating to an introducing broker).²³ It is important to note, however, that even if certain responsibilities are allocated, the broker-dealer providing market access is not relieved from its obligations under the Rule.

This allocation provision applies only to the regulatory controls and procedures. The allocation must be evidenced by written contract, which should include the scope of the arrangement and the specific responsibilities of each party. The allocation arrangement may only commence after a thorough due diligence review by the broker-dealer providing market access, in which the broker-dealer finds a reasonable basis for determining that the broker-dealer customer has both the capability and, based on its position in the transaction and its relationship with the ultimate

customer, has better access to the ultimate customer and its trading information in order to implement more effectively the specific controls and procedures allocated.

In addition, the broker-dealer providing market access may not simply rely on the customer broker-dealer's attestation that the allocated controls or procedures are being implemented in compliance with the Rule. The broker-dealer providing market access should establish, document and maintain a system to review, on a regular basis, the broker-dealer customer's performance and the allocated functions' effectiveness, and redress any issues identified or, if such issues cannot be redressed, terminate the allocation contract.

The SEC provided the following non-exhaustive list of controls that the broker-dealer providing market access could allocate to a registered broker-dealer customer:

- Control over the regulatory controls and procedures that require specific knowledge of the ultimate customer and its trading activity;
- Responsibilities under suitability and similar "know your customer" rules;
- The obligation to prevent the ultimate customer from trading securities that the customer is restricted from trading;
- Surveillance responsibilities related to manipulation or fraud, including wash sales, marking the close, and insider trading; and
- Compliance with the locate requirement of Regulation SHO, unless the broker-dealer providing market access contractually accepted the obligation to comply with the locate requirement.²⁴

Further, the broker-dealer providing market access is expected to provide the customer broker-dealer with immediate post-trade execution reports it receives from exchanges and ATSs so that the broker-dealer customer can conduct fraud and manipulation surveillance over the ultimate customer's accounts.

Additionally, there are certain conditions under which a broker-dealer may utilize, in limited instances, risk management tools or technology provided by a third party service provider that is independent of its market access customers and their affiliates. In implementing its controls, a broker-dealer may use technology or software developed by independent third parties and located at the independent third party's facilities. If a broker-dealer utilizes third-party functionalities, the broker-dealer would be expected to directly monitor and exclusively modify the controls and to perform due diligence to ensure the controls comply with the applicable provisions of the Rule. However, an independent third party may make modifications to the controls pursuant to explicit instructions provided by the broker-dealer on a case-by-case basis, rather than pursuant to standing instructions. Further, a broker-dealer may enlist an independent third party to supplement the broker-dealer's own monitoring of the operation of its controls or perform routine maintenance or technology upgrades on its risk management controls, but the broker-dealer should review any changes to such controls as part of its obligation to conduct appropriate due diligence.

The independent third party could be another broker-dealer, an exchange or ATS, a service bureau, or other entity that is not an affiliate, and is otherwise independent, of the market access customer.²⁵ In determining the independence of the third party, the substance of the relationship is more important than the form. For example, merely because a third-party is not technically an affiliate of a customer does not mean it is independent, if it has a material business or other relationship with the customer. Further, mere reliance on the third party's representation of independence is inadequate; the broker-dealer must conduct a due diligence review of the independence of the third-party.

VII. Regular Review of Risk Management Controls and Supervisory Procedures

Broker-dealers with market access are required to establish, document, and maintain a system for regularly reviewing the effectiveness of the risk management controls and supervisory procedures and for promptly addressing any issues.²⁶ Among other things, the broker-dealer must perform an at least annual review of its market access business activity to assure the overall effectiveness of the financial and regulatory risk management controls mandated by the Rule, conducted in accordance with written procedures and documented appropriately.²⁷ The written procedures and documentation of each review must be retained as part of the broker-dealer's books and records in a manner consistent with Rules 17a-4(e)(7) and 17a-4(b) of the Exchange Act.²⁸

Furthermore, the Chief Executive Officer, or equivalent officer, of the broker-dealer must annually certify that its risk management controls and supervisory procedures comply with the Rule and that such review was conducted by the broker-dealer.²⁹ These certifications are required to be retained as part of the broker-dealer's books and records in a manner consistent with Rule 17a-4(b) of the Exchange Act.³⁰ Although the annual certification required by the Rule is a separate and distinct certification, the SEC stated that, in many cases, it would expect the annual certification requirement under the Rule to be executed concurrently with the broker-dealer's annual review and certification of its supervisory systems mandated by FINRA Rule 3130.

VIII. Conclusion

The SEC has indicated its belief that the Rule is expected to benefit investors, broker-dealers, their counterparties, and the national market system as a whole by minimizing the risks related to market access arrangements by

requiring financial and regulatory risk management controls to be implemented on a uniform, market-wide basis. The adoption of the Rule, however, may impose burdens on many market participants. The Rule's effective elimination of naked access arrangements, as well as the obligations imposed on all market access arrangements, will require broker-dealers that have sponsored access and direct market access arrangements with their customers to review and modify (and possibly eliminate) some of these arrangements and update related controls. Further, the Rule will impact the competitive landscape for sophisticated traders (e.g., high-frequency traders) who are not broker-dealers, who no longer can bypass the broker-dealer to place trade orders. Despite these obstacles, it is imperative that broker-dealers with market access review and adjust their current risk management controls and supervisory procedures to conform to the new Rule before compliance is mandated on July 14, 2011.

This would include, among other things, a clearing firm reviewing, and modifying as necessary, its arrangements with introducing firms, to cover situations where the clearing firm is seeking to rely on the allocation provisions outlined above.



1. See Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 34-63241, 75 Fed. Reg. 69791 (Nov. 3, 2010) [hereinafter Final Release]; see also Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 34-61379, 75 Fed. Reg. 4007 (Jan. 19, 2010) [hereinafter Proposing Release].

2. In general, sponsored access arrangements involve a broker-dealer permitting customers to place orders that bypass the broker-dealer's trading system and are routed directly to the exchange or ATS. Generally, naked or unfiltered access

is a type of sponsored access in which no pre-trade controls or filters are applied before such orders are submitted to an exchange or ATS. See Final Release, 75 Fed. Reg. at 69793.

3. Generally, direct market access arrangements involve a broker-dealer allowing customers to place orders, but the order flows through the broker-dealer's trading system before the exchange or ATS receives the order. See Final Release, 75 Fed. Reg. at 69793.

4. See Rule 15c3-5(b), Final Release, 75 Fed. Reg. at 69825.

5. See Rule 15c3-5(d) – (e), Final Release, 75 Fed. Reg. at 69825 – 69826.

6. See Rule 15c3-5(a)(1), Final Release, 75 Fed. Reg. at 69825.

7. Broker-dealer operators of ATSs who provide non-broker-dealers access to their ATS were added to the definition of "market access" in response to comments received by the SEC regarding the Proposing Release.

8. The SEC noted that it will consider possible application of risk management controls and supervisory procedures to trading on security-based swap execution facilities and other venues that facilitate the trading of such products. See Final Release, 75 Fed. Reg. at 69795, n.20.

9. See Rule 15c3-5(a)(2), Final Release, 75 Fed. Reg. at 69825.

10. See Rule 15c3-5(b), Final Release, 75 Fed. Reg. at 69825.

11. See *id.*

12. It is important to note that this exception, which was added to the Rule in response to comments received by the SEC regarding the Proposing Release, only applies to the extent that the routing broker is providing services to an exchange or ATS in order to comply with Regulation NMS Rule 611 for NMS stocks or a national market system plan for listed options. Any routing services that go beyond this limited purpose will be required to comply with the entire scope of Rule 15c3-5.

13. For example, the controls and procedures of a broker-dealer with retail customers may differ from those of a broker-dealer with sophisticated, high-

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volume customers.

14. See Rule 15c3-5(c)(1), Final Release, 75 Fed. Reg. at 69825.

15. See Rule 15c3-5(c)(1)(i), Final Release, 75 Fed. Reg. at 69825.

16. See Rule 15c3-5(c)(1)(ii), Final Release, 75 Fed. Reg. at 69825.

17. However, such an arrangement would require that the broker-dealer, when assessing the customer's credit exposure at one exchange or ATS, assume the customer has reached its credit threshold at all other exchanges and ATSs to which it provides access.

18. However, the SEC acknowledged that there are trading strategies in which the orders entered are consistently only rarely executed. For orders submitted pursuant to such strategies, the credit or capital limits may be discounted based on the probability of execution as predicted by a reasonable risk management model. However, broker-dealers utilizing

discounting models should review on an on-going basis and modify, as necessary, the risk management models and credit and capital threshold calculations. See Final Release, 75 Fed. Reg. at 69801.

19. See Rule 15c3-5(c)(2)(i) – (iv), Final Release, 75 Fed. Reg. at 69826.

20. See Final Release, 75 Fed. Reg. at 69803.

21. See Final Release, 75 Fed. Reg. at 69804.

22. See Rule 15c3-5(d), Final Release, 75 Fed. Reg. at 69826.

23. See Rule 15c3-5(d)(1), Final Release, 75 Fed. Reg. at 69826. This exception was added in response to comments received by the SEC regarding the Proposing Release.

24. See Final Release, 75 Fed. Reg. at 69807.

25. In this context, the SEC defines the term "affiliate" to mean any person that, directly or indirectly, controls, is under common control with, or is controlled by, the customer. The SEC does not, however, define the term "independent" in the Final

Release.

26. See Rule 15c3-5(e), Final Release, 75 Fed. Reg. at 69826.

27. See Rule 15c3-5(e)(1), Final Release, 75 Fed. Reg. at 69826.

28. See *id.* Rule 17a-4(e)(7) requires every broker or dealer subject to Rule 17a-3 to maintain and preserve in an easily accessible place each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the broker or dealer until three years after the termination of the use of the manual. Rule 17a-4(b) requires every broker or dealer subject to Rule 17a-3 to preserve for a period of not less than three years, the first two years in an easily accessible place, certain records of the broker or dealer.

29. See Rule 15c3-5(e)(2), Final Release, 75 Fed. Reg. at 69826.

30. See *id.*

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