



## SEC Proposes Rule Regarding Risk Management Controls for Broker-Dealers with Market Access

On January 13, 2010, the Securities and Exchange Commission (the “SEC”) voted unanimously to propose 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”). Proposed Rule 15c3-5 (the “Proposed Rule”) would 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 the broker-dealer that could arise as a result of market access, and (2) ensure compliance with all regulatory requirements applicable in connection with market access.<sup>1</sup> The Proposed Rule 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 to reduce regulatory inconsistency and the potential for regulatory arbitrage.

### 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 volume discounts. 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 sponsored access to their member exchanges or ATSs, through either filtered or unfiltered access arrangements.

When a broker-dealer provides filtered access to customers, the customer orders flow through the broker-dealer’s systems before passing into the markets. This allows broker-dealers to pre-screen trades to ensure there are no manual errors, regulatory violations, or other issues prior to passing the trades on to the exchange or ATS. Filtered access is currently regulated by the exchanges and self-regulatory organizations; however, regulations are not uniform.

Unfiltered access arrangements, on the other hand, enable customers to execute trades directly on an exchange or ATS by using the broker-dealer’s MPID. Such trades are not pre-screened by the broker-dealer prior to execution and currently account for approximately 38% of the average daily volume in the U.S. equities market. 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 can result in erroneous orders and impede a broker-dealer’s ability to comply with pre-order regulatory requirements. The SEC is especially concerned that

<sup>1</sup> Available at <http://www.sec.gov/rules/proposed/2010/34-61379.pdf> (last viewed on February 4, 2010).

errors and unregulated access resulting from unfiltered access arrangements could cripple the trading market and increase systemic risk in the financial markets.

### The Proposed Rule

Under the Proposed Rule, any broker-dealer who offers sponsored access to its customers must establish controls and procedures reasonably designed to prevent:

- the entry of orders that exceed appropriate aggregate pre-set credit or capital thresholds for each customer and the broker-dealer and to reject orders if such orders exceed the applicable credit or capital thresholds;<sup>2</sup>
- the entry of erroneous orders;<sup>3</sup>
- the entry of orders that are not in compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;<sup>4</sup> and
- the entry of orders for securities that the broker-dealer, customer, or other person, as applicable, is restricted from trading.<sup>5</sup>

In addition, the broker-dealer's 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 the broker-dealer. 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.<sup>6</sup>

Finally, the Proposed Rule would require that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access that contain information about financial exposure faced by the broker-dealer at a given point in time, potential regulatory violations, and any other information that will better enable surveillance personnel to investigate, report, or halt suspicious or manipulative trading activity.<sup>7</sup>

The Proposed Rule would require that financial and regulatory risk management controls and supervisory procedures be under the direct and exclusive control of the broker-dealer and be monitored in real-time.<sup>8</sup> Although a broker-dealer could rely on third-party providers to assist in meeting its risk management and supervisory requirements, the broker-dealer would remain fully responsible for the effectiveness of the risk management controls. Furthermore, broker-dealers would be required to review, no less frequently than annually, the business activity of the broker-dealer 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.<sup>9</sup> Finally, the Chief Executive Officer (or equivalent officer) of the broker-dealer would 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 would be required to preserve a

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<sup>2</sup> Proposed Rule 15c3-5(c)(1)(i)

<sup>3</sup> Proposed Rule 15c3-5(c)(1)(ii)

<sup>4</sup> Proposed Rule 15c35(c)(2)(i)

<sup>5</sup> Proposed Rule 15c35(c)(2)(ii)

<sup>6</sup> Proposed Rule 15c3-5(c)(2)(iii)

<sup>7</sup> Proposed Rule 15c3-5(c)(2)(iv)

<sup>8</sup> Proposed Rule 15c3-5(d)

<sup>9</sup> Proposed Rule 15c3-5(e)

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.

### Types of Controls and Procedures Needed

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, the broker-dealer should conduct appropriate due diligence to determine limits based on the customer's business, financial condition, trading patterns, and other matters, and adequately document that decision. Broker-dealers also should 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. The 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, and applicable margin requirements. In addition, if a broker-dealer is obligated to restrict a customer from trading in a particular security, then the broker-dealer's controls must automatically prevent orders in such security from being submitted to an exchange or ATS for the account of that customer.

SEC Chairman Schapiro and various SEC commissioners have stated that the SEC's intent is to apply the Proposed Rule broadly to cover all forms of market access by broker-dealers, not only sponsored access. Comments on the Proposed Rule must be received by the SEC on or before March 29, 2010; however, noting that many broker-dealers already have some level of risk management controls in place and that the exchanges already require broker-dealers to perform a number of the functions required by the Proposed Rule, the Proposed Rule most likely will be finalized with little, if any, revisions.

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