

**MEMO# 24117**

February 3, 2010

## **SEC Proposes New Rule Relating to Market Access Arrangements**

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 4-10  
SEC RULES MEMBERS No. 15-10  
CLOSED-END INVESTMENT COMPANY MEMBERS No. 11-10  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 2-10  
ETF ADVISORY COMMITTEE No. 4-10  
RISK MANAGEMENT COMMITTEE No. 4-10     RE: SEC PROPOSES NEW RULE RELATING TO  
MARKET ACCESS ARRANGEMENTS

The Securities and Exchange Commission has published for comment new Rule 15c3-5 under the Securities Exchange Act of 1934. [\[1\]](#) The proposed rule would require brokers-dealers with access to trading directly on an exchange or alternative trading system ("ATS") to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks associated with such access. The proposal addresses concerns relating to "sponsored access arrangements" or "direct market access arrangements" where broker-dealers allow customers to trade in securities markets electronically using the broker-dealers' market participant identifiers. The Release states that given the increased speed and automation of trading on securities exchanges and ATSs, and the growing popularity of sponsored or direct market access, the SEC is concerned that the various financial and regulatory risks that arise in connection with market access may not be appropriately and effectively controlled by all broker-dealers.

### **Proposed Rule 15c3-5**

Proposed Rule 15c3-5 is divided into several provisions including those relating to: (1) the general requirement to maintain risk management controls and supervisory procedures in

connection with market access; [2] (2) specific requirements to maintain certain financial and regulatory risk management controls and supervisory procedures; (3) the requirement that controls and supervisory procedures be under the direct and exclusive control of the broker-dealer with market access; and (4) the requirement that the broker-dealer regularly review the effectiveness of the risk management controls and supervisory procedures.

### **A. General Requirement to Maintain Risk Controls**

In general, the proposed rule would require that a broker or dealer with market access, or that provides a customer or any other person with access to an exchange or ATS through use of its market participant identifier or otherwise, establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks, such as legal and operational risks, related to market access. The proposed rule would apply to trading in all securities on an exchange or ATS, including equities, options, exchange-traded funds, and debt securities.

### **B. Financial Risk Management Controls and Supervisory Procedures**

The proposed rule would require that a broker-dealer's risk management controls and supervisory procedures include certain elements. Specifically, the proposed rule would require that the controls and procedures be reasonably designed to systematically limit the financial exposure of the broker-dealer that could arise as a result of market access. The proposed rule also would require that the broker-dealer's controls and procedures be reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer, and where appropriate, more finely-tuned by sector, security, or otherwise, by rejecting orders if such orders exceed the applicable credit or capital thresholds. Applying these requirements on a pre-trade basis would effectively prohibit the practice of "unfiltered" or "naked" access to an exchange or ATS.

### **C. Regulatory Risk Management Controls and Supervisory Procedures**

The proposed rule would require that a broker-dealer's risk management controls and supervisory procedures be reasonably designed to ensure compliance with all regulatory requirements that are applicable in connection with market access. The broker-dealer's controls and procedures must assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access. Among other things, the SEC expects that broker-dealers would be able to identify the applicable customer associated with each execution report. The SEC believes that immediate reports of executions would provide surveillance personnel with important information about potential regulatory violations, and better enable them to investigate, report, or halt suspicious or manipulative trading activity. In addition, these immediate execution reports should provide the broker-dealer with more definitive data regarding the financial exposure faced by it at a given point in time. The Release states that this should provide a valuable supplement to the systematic pre-trade risk controls and other supervisory procedures required by the proposed rule.

## **D. Direct and Exclusive Broker-Dealer Control Over Financial and Regulatory Risk Management Controls and Supervisory Procedures**

The proposed rule would require the financial and regulatory risk management controls and supervisory procedures to be under the direct and exclusive control of the broker-dealer that is subject to the proposed rule. The Release states that this provision is designed to eliminate the practice whereby the broker-dealer providing market access relies on its customer, a third party service provider, or others, to establish and maintain the applicable risk controls.

## **E. Regular Review of Risk Management Controls and Supervisory Procedures**

A broker-dealer that is subject to the proposed rule would be required to establish, document, and maintain a system for regularly reviewing the effectiveness of its risk management controls and supervisory procedures under the rule and for promptly addressing any issues that may arise. Among other things, the broker-dealer would be required to review, no less frequently than annually and in accordance with written procedures, the business activity of the broker-dealer in connection with market access to assure the overall effectiveness of the controls and procedures. In addition, the Chief Executive Officer (or equivalent officer) of the broker-dealer would be required, on an annual basis, to certify that the risk management controls and supervisory procedures comply with the proposed rule and that the regular review has been conducted.

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### **endnotes**

[1] Securities Exchange Act Release No. 34-61379 (January 19, 2010), 75 FR 4007 (January 26, 2010) (“Release”). The Release can be found on the SEC’s website at <http://www.sec.gov/rules/proposed/2010/34-61379.pdf>. Comments on the proposal are due to the SEC no later than March 29, 2010.

[2] For purposes of the proposed rule, the term “market access” is defined as access to trading in securities on an exchange or ATS as a result of being a member or subscriber of the exchange or ATS, respectively. The Release states that the proposed definition is intentionally broad so as to include not only direct market access or sponsored access services offered to customers of broker-dealers, but also access to trading for the proprietary account of the broker-dealer and for more traditional agency activities.