

SEC Limits Direct Market Access

Introduction

On November 3, 2010, the SEC adopted Rule 15c3-5, which effectively prohibits “naked access” to the securities markets. The new rule requires broker-dealers to establish and maintain a system of risk management controls and supervisory procedures that control the access they provide to markets. These controls and procedures must be reasonably designed to systematically limit the financial exposure of the broker-dealer that could arise as a result of market access, and to ensure compliance with all regulatory requirements that apply to providing market access.

The rule is effective sixty days after publication in the *Federal Register* and compliance is required six months thereafter.

We describe below the key aspects of the final rule and the changes from the proposed rule.

The Final Rule

Definition of Market Access

The rule applies to broker-dealers with “market access,” which is defined as access to trading in securities on an exchange or alternative trading system. Unlike the proposed rule, the final rule also applies to providing access to non-broker-dealers to trade on an ATS.¹

The rule applies to access to exchanges and ATSs in all securities, including equities, options, and fixed income securities. The rule also will apply to security-based swaps if they become traded on an exchange. In addition, the SEC states in the adopting release that it will consider applying the rule to trading on security-based swap execution facilities and other venues of security-based swaps as they develop.

The SEC notes in the adopting release that the definition is purposefully broad to cover not just direct market access offered to customers of a broker-dealer, but also the broker-dealer’s own proprietary trading.

Financial Risk Management Controls and Supervisory Procedures

The risk management controls and supervisory procedures required by the rule must be reasonably designed to systematically limit the financial exposure of the broker-dealer, prevent the entry of orders that exceed pre-set credit or capital thresholds in the aggregate for each customer and the broker-dealer, and prevent the entry of erroneous orders.

The SEC recognizes that a “one-size-fits-all” model for risk management controls and supervisory procedures is not appropriate, and notes the flexibility of the “reasonable policies and procedures” approach of the rule to fit the business models of different firms. The SEC states that in certain circumstances it may be appropriate for the controls to be finely tuned by sector or security.

Controls Based on Orders Entered, Not Executed. Unchanged from the proposal is the requirement that the broker-dealer must assess compliance with the thresholds based on orders entered, as opposed to executed on an exchange or ATS. However, in response to comments, the SEC notes that active trading

¹ The final rule excepts broker-dealers that provide outbound routing services for an exchange or ATS for purposes of compliance with Regulation NMS, although these broker-dealers still must prevent the entry of erroneous orders.

strategies may warrant discounting the credit or capital exposure assigned to orders to account for the likelihood of actual execution as demonstrated by reasonable risk management models. A broker-dealer that engages in a discounting methodology must monitor the accuracy of its models on an ongoing basis and make adjustments as warranted.

Regulatory Risk Management Controls and Supervisory Procedures

The final rule requires a broker-dealer with market access to maintain risk management controls and supervisory procedures that are reasonably designed to ensure compliance with all applicable federal securities laws and rules, and SRO rules.

Specifically, the controls and procedures must be designed to:

- prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;
- prevent the entry of orders for securities for a broker-dealer, customer, or other person if such person is restricted from trading those securities;
- limit market access only to persons and accounts pre-approved and authorized by the broker-dealer; and
- assure that appropriate surveillance personnel receive immediate post-trade exception reports that identify the applicable customer associated with each exception.

The adopting release clarifies that only regulatory requirements that can effectively be complied with before an order is entered on an exchange or ATS must be satisfied on a pre-trade basis, such as the marking and locate requirements of Regulation SHO, and the conditions for “intermarket sweep orders” under Regulation NMS. The ability to provide monitoring and surveillance immediately would be required. In contrast, surveillance for manipulation and fraud could occur post-trade in a timely fashion as warranted by the facts and circumstances, but need not occur immediately.

The SEC believes that the new rule in many cases will reinforce existing regulatory risk management controls of broker-dealers and will not require most broker-dealers to substantially change their existing monitoring or surveillance practices.

Direct and Exclusive Broker-Dealer Control and Allocation of Responsibilities

The final rule requires the financial and regulatory risk management controls and supervisory procedures to be under the direct and exclusive control of the broker-dealer. A broker-dealer can use third-party technology to implement these controls as long as the technology is under the direct supervision and control of the broker-dealer. Thus, the broker-dealer must retain the ability to make adjustments to and monitor the operation of the controls, and the third party must be independent of market access customers.

Allocation Between Broker-Dealers. One of the most significant changes from the proposal is that the final rule permits a broker-dealer providing market access to reasonably allocate, by written contract, control over specific regulatory risk management controls and supervisory procedures to a customer that is a registered broker-dealer. To do so, the broker-dealer providing market access must have a reasonable basis for determining that such broker-dealer customer has better access to the ultimate customer and its trading information such that it can more effectively implement the specified controls and procedures. However, even if responsibilities are allocated between broker-dealers, the broker-dealer providing access has ultimate responsibility for the obligations under the rule. Thus, market participants should take care in ensuring that any contract entered into to allocate responsibilities between broker-dealers is carefully drafted to clearly define the responsibilities of each party and the remedies available in the event of regulatory shortcomings.

Regular Reviews and CEO Certification

Broker-dealers that are subject to the proposed rule are required to establish, document, and maintain a system for regularly reviewing their risk management controls and supervisory procedures. They must include an annual review to assure the effectiveness of the controls and procedures. The review would need to be conducted in accordance with written procedures that are reasonably designed to assure that the broker-dealer's controls and procedures are adjusted as necessary.

The CEO or equivalent officer of the broker-dealer providing access must certify annually that the risk management controls and supervisory procedures comply with the requirements of the rule and that the broker-dealer conducted the required annual review. This certification can be combined with existing certifications, such as the certification required under FINRA Rule 3130, but the combined certification must cover the requirements under new Rule 15c3-5.

Conclusion

Rule 15c3-5 was modified modestly to respond to comments, particularly in allowing a limited allocation of responsibilities among broker-dealers. Nonetheless, the rule will require significant changes in the operations of broker-dealers that have direct access to trading markets and offer such access to other firms, and potentially will have competitive implications for high frequency traders that are not broker-dealers.

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