

SEC Proposes Rule Regarding Sponsored Access

Contents

Introduction	1
The Proposal	1
Financial Risk Management Controls and Supervisory Procedures	2
Regulatory Risk Management Controls and Supervisory Procedures	2
Direct and Exclusive Broker- Dealer Control	3
Regular Reviews	3
Commentary	3
Breadth of Scope.....	3
Limitations in Scope	5
Conclusion	5
References	6

Introduction

The Securities and Exchange Commission (the “SEC”) has proposed to close the curtain on “naked access” to the securities markets.¹

In its most recent equity market structure proposal,² the SEC on January 19, 2010 [proposed a new rule](#) that would effectively prohibit unfiltered access to markets by requiring broker-dealers that have direct access to exchanges or alternative trading systems (“**ATSS**”) to maintain risk management controls and supervisory procedures to manage the financial, regulatory, and other risks associated with proprietary and customer access to such markets. By requiring such controls and procedures to be under the broker-dealer’s “direct and exclusive supervision,” the proposal mandates that customer orders under market access arrangements must pass through systems controlled by the sponsoring broker-dealer.

The rule was proposed by the SEC simultaneously with approval of a more limited Nasdaq sponsored access rule change, which would require additional controls but not ban direct access. The Nasdaq rule and other related self-regulatory organization (“**SRO**”) guidance are described in the text boxes below.

We describe below the key aspects of the SEC proposal and discuss some of the practical and policy considerations it raises.

The Proposal

Proposed Rule 15c3-5 under the Securities Exchange Act of 1934 would apply to broker-dealers with access to trading in securities on an exchange or ATS as a result of being a member or subscriber of the exchange or ATS (“**market access**”), or that provide this market access to others. These broker-dealers would be required to 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 the market access business activity. The proposal would mandate an annual review, and a CEO certification, of the effectiveness of these controls and procedures.

¹ Exchange Act Release No. 61379 (Jan. 19, 2010).

² In the last several months, the SEC has proposed a ban on flash orders ([Exchange Act Release No. 60684 \(Sept. 18, 2009\)](#)), proposed measures that will illuminate certain dark pools ([Exchange Act Release No. 60997 \(Nov. 13, 2009\)](#)), and issued a concept release on equity market structure issues, including co-location, high frequency trading, and undisplayed liquidity. ([Exchange Act Release No. 61358 \(Jan. 14, 2010\)](#)). Links to Davis Polk memoranda regarding these releases can be found below.

Nasdaq Rule

Amended Nasdaq Rule 4611:

- Permits members to provide access to Nasdaq by passing orders through the member's own systems or through other means.
- If the member provides market access other than through its own system, it must contractually require customers to comply with applicable laws, trade within agreed limits, and grant access to their books and records. Special requirements apply where access is provided through a third party provider.
- Mandates controls reasonably designed to prevent trading in excess of credit thresholds or of restricted products, submission of erroneous/duplicative orders and regulatory violations.
- Prescribes audit trail, reporting and supervisory review standards.

Other SRO Guidance

Other SRO guidance includes:

- NYSE guidance that requires members be responsible for all regulatory requirements relating to customer orders, and to establish written procedures and controls concerning access, order accuracy, error minimization and credit limits.
- NASD/FINRA guidance on members' responsibility for orders entered using their market participant ID (MPID), even if entered by nonmember customers. Guidance stresses supervision, due diligence, and contractual arrangements.
- Various exchanges also have rules concerning market access provision.

Financial Risk Management Controls and Supervisory Procedures

The risk management controls and supervisory procedures required by the SEC proposal must be reasonably designed to "systematically limit the financial exposure of the broker-dealer that could arise as a result of market access." The release is clear that such controls must be applied on a pre-trade basis, which effectively would prohibit broker-dealers from providing unfiltered access to an exchange or ATS. This contrasts with the Nasdaq rule, which permits orders to be routed without passing through a member system prior to reaching Nasdaq.

Controls Based on Orders Entered, Not Executed. The broker-dealer must assess compliance with the thresholds based on orders entered, as opposed to executed on an exchange or ATS, which may impinge upon certain common trading strategies that involve sending multiple orders to various market centers simultaneously with the expectation that many will be cancelled or expire unfilled.

Early Warnings. In the proposing release the SEC notes that broker-dealers should consider establishing early warnings that alert the broker-dealer when the thresholds are being approached, and requests comment on this point.

Regulatory Risk Management Controls and Supervisory Procedures

The SEC proposal would require a broker-dealer with market access to maintain risk management controls and supervisory procedures that are reasonably designed to ensure compliance with all federal securities laws and rules, and rules of any SRO, that are applicable in connection with market access.

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 access to trading systems and technology that provide 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.

These pre-trade controls would be required to assure compliance with an unspecified universe of regulatory requirements. Examples given in the release include SEC rules under Regulation SHO (*i.e.*, locate requirements) and Regulation NMS, and margin requirements. In addition, the SEC expects that broker-dealers would have controls that include:

- 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.

Direct and Exclusive Broker-Dealer Control

Proposed Rule 15c3-5 would require the financial and regulatory risk management controls and supervisory procedures described above to be under the direct and exclusive control of the broker-dealer. Thus, a broker-dealer would not be permitted to rely on its customer or a third party service provider to establish and maintain the applicable risk controls. But a broker-dealer could use third party technology to implement these controls as long as the technology is under the direct supervision and control of the broker-dealer.

The release does not distinguish between customers that are broker-dealers and non-broker-dealer customers. Thus, even if a customer is a broker-dealer, the sponsoring broker-dealer must be responsible for the risk management controls.

In contrast, the Nasdaq rule allows the sponsoring member to enter into contractual arrangements that obligate the customer to comply with the risk management standards that are required.

Regular Reviews

Broker-dealers that are subject to the proposed rule would be required to establish, document, and maintain a system for regularly reviewing their risk management controls and supervisory procedures, including a review not less than annually, 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 proposed rule would require the CEO or equivalent officer of the broker-dealer to 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.

Commentary

The proposal is notable for both its breadth and its limitations in scope.

Breadth of Scope

The scope of the proposal is broad both in its specific requirements and the manner of achieving its goals.

Scope of Control Requirements: Although the proposed rule may have been prompted by recent concerns about naked sponsored access, it is drafted broadly to require the same level of broker-dealer controls and procedures for proprietary trading as for customer access. The SEC believes that the proprietary requirement should not require major changes for most broker-dealers because they should already have supervisory controls and procedures in place to monitor and control their access. The proposed rule is expansive concerning the required controls and imposes a specific annual review and certification process regarding the procedures.

Pre-trade Controls: For many customers, the pre-trade controls requirement will change their access methods significantly, requiring their orders to pass through the risk management system of the sponsoring broker-dealer before accessing the exchange or ATS. The release estimates that this will delay customer order executions between 200-500 microseconds. Some commentators have suggested that high frequency trading firms that currently use unfiltered access to reduce latency and maintain confidentiality of their orders may consider registering as a broker-dealer to access exchange markets directly.

Increased Costs: For firms that offer sponsored access, the proposal could require systems and procedures changes and raise costs.

Difficulties of Compliance: The requirement to have controls and procedures with respect to regulatory requirements applies broadly to the risks of the “business activity” of market access, which itself is defined expansively to include access to trading in securities on an exchange or ATS. Arguably, this requirement to have controls and procedures for access to trading in securities could include all regulatory issues involving this trading, including traditional trading issues such as front running and manipulation. Although the specific examples in the proposal focused on order execution requirements, rules are often applied expansively once adopted.

Moreover, it is particularly difficult for a broker-dealer to monitor for the regulatory compliance of customers of other intermediary broker-dealers that use its market access services. Many regulatory requirements take into account detailed factors relating to the circumstances of the ultimate end customer. It is not clear that an ultimate market access provider would have access to the requisite account-specific information, particularly where the market access provider is neither a prime broker nor a clearing firm for its broker-dealer customer. The release suggests that the duty can be allocated among broker-dealers, but the rule is far from clear on this point and the SEC specifically requests comment on it.

Multiple Liability Considerations: The rule raises the possibility of double liability for violation of a regulatory requirement, such as Regulation SHO, resulting from unauthorized use of access in a broker-dealer’s proprietary account, based on the underlying violation and inadequate controls. Moreover, since FINRA and many exchanges have requirements that relate to (i) establishment of controls generally, and (ii) market access specifically, the SEC’s regulation in this area will increase the number of regulators policing and enforcing overlapping regulatory requirements. On the other

hand, the proposal may simply establish uniform practices across diverse markets, which will in effect be enforced by the SROs in the normal course.

Limitations in Scope

Principles and Procedures: The proposal relies on a principles-based approach to avoid detailing specific procedures that might prove unworkable for various broker-dealers' models. In addition, the proposal relies on controls and procedures rather than proscriptions, similar to the approach used in the order protection rule under Regulation NMS (Rule 611). This approach reduces the risk of liability for specific access incidents that may occur. However, while the principles/procedures approach allows broker-dealers to tailor their systems to their access business, it also lends itself to examination and enforcement with 20-20 hindsight, particularly after an incident has occurred.

Limited Trading Centers: The proposal applies to access to trading securities on an exchange or ATS, but does not apply to upstairs trading or trading with a wholesale market maker. Therefore, a large volume of trading would not be subject to the protections of the proposal. Although the SEC may believe that the proprietary nature of this trading creates incentives for the proprietary firm to avoid taking on excessive risk from customers, the concerns regarding regulatory compliance would seem equally applicable to this trading. The release also requests comment on whether trading in debt, equities and options should be treated differently.

Conclusion

The SEC's sponsored access proposal would require significant changes in the operations of broker-dealers that have direct access to trading markets, in particular those that offer sponsored access to other firms, and would require guidance from the SEC regarding compliance with the principles described in the rules. It also would competitively affect the current users of sponsored access.

Comments on the release are due by March 29, 2010.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Annette L. Nazareth
202 962 7075
annette.nazareth@davispolk.com

Lanny A. Schwartz
212 450 4174
lanny.schwartz@davispolk.com

Gerard Citera
212 450 4881
gerard.citera@davispolk.com

Robert L.D. Colby
202 962 7121
robert.colby@davispolk.com

References

[SEC Issues Concept Release on Equity Market Structure](#)

[SEC Proposes Additional Transparency for “Dark Pools” and Intends to Issue Additional Market Structure Proposals and Concept Release Soon](#)

[SEC Proposes to Ban “Flash” Orders; Announces Broad Review of Market Structure Issues](#)

© 2010 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.