

## Proposed SEC Rule May Significantly Affect Direct Market Access

### Introduction

The Securities and Exchange Commission ("SEC") recently announced actions that may alter the relationships between many "buy side" firms and their executing brokers. Among these is a proposed rule by the SEC that is designed to force brokers that offer direct market access to their customers, to employ pre-trade filters and establish controls to manage risk and prevent regulatory compliance failures. The SEC also announced that it has approved a related rule filing by Nasdaq that will require its members offering direct market access to, among other things, amend their existing contractual agreements in order to obtain additional financial information from their customers, and to assume greater responsibility for their customers' trading on Nasdaq. Both actions are controversial.

### Proposed Exchange Act Rule 15c3-5

With technology advances, increased transparency, and competition among market centers, buy side firms have asserted greater control of their own trade executions by using order execution software that bypasses trading desks at traditional brokerage firms. Access to markets still requires, in most cases, the use of a registered broker-dealer acting as an intermediary. However, trade execution systems offered by brokers that are resident at the trading desks of their customers, allow many buy side firms to manage their executions by routing orders directly to a particular market ("direct market access" or "DMA"). Even though quotes originate at the customer's trading desk, the market centers display the participant identifier ("MPID") of the sponsoring broker, who is ultimately responsible for regulatory compliance and any economic losses associated with the executions.

The two major types of DMA relationships are those that force order flow through the broker-dealer's internal compliance engines ("direct access") and those that permit the customer to bypass the trading system of the broker-dealer entirely and route orders directly to a market for execution ("sponsored access"). Sponsored access arrangements are further differentiated between those that have pre-trade controls, or filters, in the order execution software ("filtered access"), and those that provide unfiltered access ("naked access" or "unfiltered access").

In connection with its broader post-Regulation NMS review of capital markets,<sup>1</sup> on January 19, 2010 the SEC published a rule proposal under the Securities Exchange Act of 1934 ("Exchange Act") that would directly address the proliferation of DMA arrangements.<sup>2</sup> The proposed rule, rule 15c3-5 ("Proposed Rule"), responds to growing concern that DMA arrangements present significant risks to both sponsoring broker-dealers and the national market system.<sup>3</sup>

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<sup>1</sup> For some time, the SEC has been examining a variety of market structure issues, including dark pools, co-location, flash trading, and high frequency trading. See, e.g., Exchange Act Release No. 61358 (January 13, 2010) (concept release on equity market structure); and Exchange Act Release No. 60684 (Sept 18, 2009) (addressing dark pools).

<sup>2</sup> Exchange Act Release No. 61379 (January 19, 2010) ("Proposing Release").

<sup>3</sup> The Proposing Release also contains examples of trade errors in recent years that are notable because they caused significant market declines or resulted in substantial losses. In some cases, these errors reflected minor pricing differences that were magnified across a large volume of transactions, and in one notable case on the Tokyo Stock Exchange, an inaccurate limit price on a block order that resulted in a significant loss.

The Proposed Rule would apply to brokers offering DMA arrangements to customers seeking to execute transactions in equities, options, ETFs, and many forms of debt, that occur directly on an exchange or through an Alternative Trading System (“ATS”).<sup>4</sup> The Proposed Rule would require a broker-dealer to have the following controls:

- *Financial Risk Management Controls.* Under the Proposed Rule, a broker offering DMA must adopt a system of risk management controls and supervisory procedures reasonably designed to manage financial, regulatory, and other risks associated with DMA arrangements. More specifically, the broker would be required to have controls to prevent erroneous order entries and establish, on a customer-by-customer basis, pre-set credit or capital thresholds. The Proposed Rule states that these controls may be, where appropriate, more finely-tuned by sector, security, or otherwise.
- *Regulatory and System Controls.* A related, but more extensive, requirement is that any customer orders also must be pre-filtered to assure that they comply with any regulatory requirements, including any trading restrictions, that may apply to that customer, market center, or security.<sup>5</sup> This requirement eliminates naked access. Controls also must be in place to assure that access to the trading system is limited to approved persons,<sup>6</sup> and that appropriate surveillance personnel of the

<sup>4</sup> The Proposed Rule does not define the word “exchange.” It is not clear at this time whether it would apply to orders executed offshore on foreign markets. There are more than 50 ATS registered in the United States pursuant to Rule 301 of the Exchange Act, and others operating outside the United States.

<sup>5</sup> The SEC indicates that relevant trading rules might be those relating to special order types, trading halts, odd-lot orders, and SEC rules under Regulation SHO and Regulation NMS, as well as applicable margin requirements. It also suggests that a broker may not offer executions in securities if it is not qualified to trade those securities directly (e.g., because it is not approved by FINRA to offer the products or does not have appropriately licensed persons).

<sup>6</sup> According to the SEC, these controls and procedures would include: screening customers and their personnel who will be permitted to use the trading systems or other technology and limiting access to the systems. Historically, those permitted access to trading systems have been so “authorized” by the customer. The Proposed Rule, however, requires that the broker “pre-approve” persons with access to the broker’s trading systems, and assure that such persons are appropriately “vetted” and trained.

broker receive immediate post-trade execution reports that result from market access.<sup>7</sup>

For business and compliance purposes, most of the controls required by the Proposed Rule are currently in place at brokers. Moreover, as noted below, rules are being considered or have been adopted by exchanges addressing similar issues. The Proposed Rule, however, would create a national standard that would also apply to ATS. The SEC anticipates that the Proposed Rule may affect over 1,200 brokers that offer DMA arrangements to their customers. The initial annual costs per broker may exceed \$50,000 according to the SEC. No discussion is provided of the economic effect on their customers.

While most of the emphasis in the Proposing Release is on systems development, there are likely to be more significant effects if the Proposed Rule is adopted in its current form. The following are some of the potential effects of the Proposed Rule:

*Ban on Naked Access.* Perhaps the most significant and immediate effect of the Proposed Rule would be on high frequency trading firms. These firms, which are believed to account for 60%–75% of trading volume in national market system securities, rely on rapid executions to arbitrage opportunities in the market. A ban on naked access, and the requirement for pre-trade filters that increase latency in executions by even milliseconds, may force some firms to form their own broker-dealers in order to avoid order execution delays. Concerns over the confidentiality of trading strategies may also lead some customers to form proprietary brokerage firms.<sup>8</sup>

*Exclusive Control.* In the Proposed Rule, and throughout the Proposing Release, the SEC emphasizes the need for the broker to maintain “exclusive control” of the order routing software. The effect on third-party software vendors, and both buy side and sell side firms that rely on these systems, is uncer-

<sup>7</sup> Both types of controls must be documented and are reviewed at least annually by the broker, with the CEO of the broker certifying compliance.

<sup>8</sup> Generally, the process of forming or purchasing a broker and receiving regulatory approvals will take six months or longer.

tain.<sup>9</sup> Individual brokerage firms may lack the resources, in some cases, to create systems with the same level of compliance sophistication that can be found in third-party systems. Forcing firms to act independently may actually undermine the quality of trading controls.

The degree of exclusivity over control may also be an issue for brokers and their customers. In some areas, customers or correspondent brokers may have unique needs that a “one-size-fits all” filter may not accommodate. In these instances, the customer may need the ability to work with the broker to craft a systems solution. It is uncertain, based on the Proposed Rule, how much interface with customers would be permitted in the future.

*Increased Liability for Brokers.* Perhaps the most significant issue raised by the Proposed Rule is the degree to which it will shift economic or regulatory liability to brokers. Generally, DMA agreements state that the broker’s trading platform is offered on an “as is” basis and disclaim any liability of the sponsoring broker. It is not clear, therefore, how the “exclusive control” requirements and express obligation to prevent erroneous trades set forth in the Proposed Rule would alter the brokers’ responsibility to their customers.<sup>10</sup> Moreover, although the SEC passes over the issue lightly, while brokers would be required to have filters to reject “erroneous trades,” there is no single definition of an “erroneous trade” that applies across all markets and to all securities, and no suggestion by the SEC that all

brokers must adopt a single standard across markets, and what that standard might be.<sup>11</sup>

The Proposed Rule at first blush seems aimed at solely quantitative filters, such as those that might apply under Reg. NMS or Reg. SHO. If adopted, however, the Proposed Rule may open the door for enforcement actions against the broker in many areas based on strict liability rather than “knowing” participation. Brokers who, in hindsight, did not have “reasonable procedures,” and therefore failed to detect and prevent unlawful trading strategies by their customers, including insider trading or front running, may be subject to sanctions.<sup>12</sup> For this reason, one area of significant concern is the extent to which the SEC or self-regulatory organizations are seeking to “deputize” brokers and will expect them to exercise their due diligence and trading oversight to prevent all regulatory violations by DMA customers.

## Nasdaq Rule

An appendix to the Proposing Release discusses current efforts by the self-regulatory organizations (“SROs”), notably Nasdaq and the NYSE, to address issues raised by DMA. The Nasdaq rule proposal, whose adoption was announced by the SEC in the Proposing Release, was considered a proxy for other SROs that may seek to adopt similar rules.<sup>13</sup> Nasdaq’s rule, which was opposed by some buy side firms, contains elements that are similar to the Proposed Rule.<sup>14</sup> However, unlike the SEC’s Proposed Rule, the Nasdaq rule is effective currently and will result in pressure to change contractual

<sup>9</sup> The SEC believes that a broker-dealer should not be permitted to delegate the power to develop controls to the customer or to a third party. However, it states that broker-dealers would have the flexibility to seek out risk management technology developed by third parties, but only if the third parties are independent of the customers provided with market access, and the broker-dealer performs appropriate due diligence. The Proposing Release does not identify any significant alternatives; commenters in the past have suggested that some compliance filters should be applied at the market center level, rather than by individual brokers, as a means to assure uniform practices.

<sup>10</sup> Often, a DMA customer must represent that it is familiar with the regulations addressing trading on a particular market center. Thus, a related issue is the extent to which brokers may be responsible for approving access to their systems by a customer’s employees who are not appropriately trained.

<sup>11</sup> Nasdaq has detailed rules addressing clearly erroneous (or outlier) trades. See Nasdaq Rule 11890. However, the concepts may not apply on every market center or ATS, and the broker will be required to adopt its own definition.

<sup>12</sup> Many brokers already conduct surveillance reviews to detect some types of manipulative behavior, such as “marking the close.” However, illegal conduct may be very difficult to detect, particularly when a customer has multiple brokerage arrangements. Under the Nasdaq rule, the broker specifically must monitor for, among other things, market manipulation and insider trading.

<sup>13</sup> See Exchange Act Release No. 61345 (January 13, 2010) (Naked Market Access Approval Order).

<sup>14</sup> Nasdaq Rule 4611.

terms between the customer and the broker, requiring the customer to:

- provide access to books and records, financial information and otherwise cooperate with the sponsoring member for regulatory purposes;
- maintain its trading activity within the credit thresholds set by the sponsoring member; and
- allow immediate termination of the access arrangement if it poses serious risk to the broker or “the integrity of the market.”

## Conclusion

The SEC’s Proposed Rule, and the corresponding rule-making by the SROs, is likely to raise significant issues for both brokers and their DMA customers. While the full extent of the broker’s obligations to its customers and the markets is not clear at this time, it is evident that brokers no longer will be able to rely upon agreements that attempt to shift liability to their customers for regulatory compliance. In addition, it is possible in light of the Nasdaq rule, that brokers may begin policing DMA

relationships as though the transactions were occurring in their own proprietary accounts.

Some unintended consequences of the Proposed Rule, as currently crafted, may include limitations on creative trading strategies, the formation of smaller and less well-capitalized brokers, and greater reliance on proprietary order routing software that may or may not reflect an adequate investment in compliance filters. While the Nasdaq rule is currently effective, the comment period for the Proposed Rule expires on March 29, 2010. The SEC has indicated that it intends to act quickly following the close of the comment period on the Proposed Rule.

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