Client Advisory

Katten
Katten Muchin Rosenman LLP

Financial Services

January 29, 2010

SEC Proposes New Market Access Rule and Approves Modifications to the Sponsored Access Rule of the Nasdaq Stock Market

On January 13, the Securities and Exchange Commission (SEC or "Commission") proposed a market access rule that would require broker-dealers with access to trading directly on an exchange or alternative trading system (ATS)—including broker-dealers providing sponsored or direct market access—to implement risk management controls and supervisory procedures designed to manage the financial, regulatory and other risks arising from such access. The comment period on the SEC's proposed rule is 60 days.

At the same time, the Commission approved modifications to the Nasdaq Stock Market's sponsored access rule. Nasdaq members should note that Nasdaq announced that the new requirements have not been implemented and that Nasdaq is coordinating with the SEC to develop an appropriate implementation schedule.[1]

This advisory summarizes both the proposal from the SEC on market access and the approved Nasdaq rule.

SEC Market Access Proposed Rule 15c3-5

The SEC's proposed Rule 15c3-5 is designed to prohibit the "unfiltered" or "naked" access to an exchange or ATS. The proposal is intended to apply to trading in all securities on an exchange or ATS, including equities, options, exchange-traded funds and debt securities. As noted above, the comment period for this proposal is 60 days.

Proposed Rule 15c3-5 would require brokers or dealers with access to trading securities directly on an exchange or ATS to put in place risk management controls and supervisory procedures designed to 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 are applicable in connection with market access.

The SEC's proposals for financial and regulatory risk controls are intended for firms with direct market access engaged in proprietary trading as well as firms that provide market access to clients (i.e., sponsored and direct access). The SEC is concerned about preventing any potential risks of trading errors or a rapid series of errors arising from computer or human error. It is the Commission's preliminary view that risk management controls that are not applied on a pre-trade basis or that are not under the exclusive control of the broker-dealer are inadequate to address the risks of market access in today's environment.

[1] See Nasdaq Sponsored Access Update (January 14, 2010).

For more information, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten's Financial Services Practice.

Janet M. Angstadt
312.902.5494 / janet.angstadt@kattenlaw.com

Timothy Elliott
312.902.5438 / timothy.elliott@kattenlaw.com

Daren R. Domina
212.940.6517 / daren.domina@kattenlaw.com

Ross Pazzol
312.902.5554 / ross.pazzol@kattenlaw.com

James D. Van De Graaff
312.902.5227 / james.vandegraaff@kattenlaw.com

Proposed Financial Risk Management Controls. The SEC's proposal would require broker-dealers with market access to put in place financial risk management controls designed to: (1) prevent the entry of orders that exceed pre-set credit or capital thresholds, and (2) prevent erroneous orders by rejecting orders that exceed price or size parameters or that indicate duplicative orders. The SEC's expectation is that a firm will not be able to place orders on an exchange or ATS unless these orders meet these tests. Under proposed Rule 15c3-5, these financial risk controls must be applied to all of the firm's orders, regardless of whether these orders are generated by the firm or by clients for whom the firm provides market access.

Proposed Regulatory Risk Management Controls. The proposed regulatory risk management controls must be reasonably designed to prevent the submission of orders that do not comply with all regulatory requirements.[2] Among other things, a broker-dealer would be required to implement controls that: (1) prevent the entry of orders that would not comply with all regulatory requirements; (2) prevent the entry of orders that the broker-dealer or customer is restricted from trading; (3) restrict market access technology and systems to authorized persons; and (4) ensure that appropriate surveillance personnel receive immediate post-trade execution reports. As with the proposed financial risk management controls, these regulatory risk controls must be applied to all of a firm's orders.

Additional Requirements. The financial and regulatory risk management controls and supervisory procedures required by the proposed rule must be under the direct and exclusive control of the broker-dealer with market access.[3] In addition, a broker or dealer with market access would be required to review the effectiveness of the risk management controls and supervisory procedures required by proposed Rule 15c3-5. Among other things, the broker-dealer would be required to review on an annual basis the business activity of the broker-dealer in connection with market access to assure the effectiveness of the risk management controls and supervisory procedures, and to document that review. In addition, the chief executive officer (or equivalent officer) of the broker-dealer would be required annually to certify that the financial and regulatory risk management controls and supervisory procedures comply with proposed Rule 15c3-5.

Nasdaq Sponsored Access Rule Applies to Direct Market Access and Sponsored Access

Nasdaq's sponsored access rule, Rule 4611(d), applies to both direct market access and sponsored access arrangements between a member and all of its clients, including non-broker-dealers, non-member broker-dealers and other Nasdaq members.[4] For both types of access the clients are defined as "Sponsored Participants" and the members providing access are defined as "Sponsoring Members."

Financial and Regulatory Controls. Members granting Sponsored Participants either direct market access or sponsored access must have financial controls in their systems that are reasonably designed to: (1) prevent the Sponsored Participant from exceeding pre-set credit thresholds; (2) prevent Sponsored Participants from trading products that either the Sponsoring Member or Sponsored Participant is restricted from trading; and (3) prevent Sponsored Participants from submitting erroneous orders by rejecting orders that exceed price or size parameters or that duplicate orders.[5]

In addition, Sponsoring Members must have regulatory controls in their systems that are reasonably designed to ensure compliance with all applicable regulatory requirements. The Nasdaq rule defines "regulatory requirements" as "all applicable federal securities laws and rules and [Nasdaq] rules, including but not limited to the Nasdaq Certificate of Incorporation,

[2] The Commission intends that the definition of "regulatory requirements" will include, for example, exchange trading rules relating to special order types, trading halts, odd-lot orders, SEC rules under Regulation SHO and Regulation NMS, as well as applicable margin requirements.

[3] As the SEC notes, this provision is designed to prohibit a broker-dealer from relying on a its customer, a third party service provider or others to establish and maintain the applicable risk controls. Although the text of proposed Rule 15c3-5 states that the risk management controls must be "under the direct and exclusive control" of the broker-dealer, the Commission states that a broker-dealer may have the flexibility to use risk management technology developed by third parties. The SEC seeks comment on whether broker-dealers could effectively comply with the proposed rule if the broker-dealer relied on the technology of a third party.

[4] Nasdaq defines "sponsored access" as a member allowing a client to enter orders into Nasdaq but where the orders do not pass through the member's system prior to reaching Nasdaq. In contrast, "direct market access" is defined as a member allowing a client to make decisions regarding order routing and order entry but the orders pass through the member's system prior to reaching Nasdaq.

[5] While not specifically addressed in the SEC's approval of the Nasdaq sponsored access rule, it appears that a member would have to utilize Nasdaq's Pre-Trade Risk Management system or other similar system to prevent potentially erroneous transactions.

Bylaws, Rules and procedures with regard to [Nasdaq.]"[6] In addition, each Sponsoring Member must ensure that supervisory personnel receive and review timely reports of all trading activity by its Sponsored Participants.[7] Nasdaq specifically notes that Sponsoring Members must monitor Sponsored Participants for market manipulation and insider trading.

Contractual Provisions. Members that provide clients with sponsored access—but not direct market access—must enter into agreements with these clients in which the clients agree to the following conditions: (1) all client trading activity must comply with regulatory requirements; (2) the client must provide books and records and financial information on request that are necessary for the Sponsoring Member to comply with its regulatory obligations; (3) the client must trade within the credit, product or other financial limits set by the Sponsoring Member; (4) all technology permitting the sponsored access must be maintained in a physically secure manner; and (5) access to Nasdaq may be immediately terminated if the access poses a serious risk to the Sponsoring Member or to the integrity of the market. In addition, these contracts must require the Sponsoring Member to provide training to the client before the client may utilize the sponsored access arrangement.

Click **here** to read the SEC's Release No. 34-61379; File No. S7-03-10 RIN 3235-AK53, Risk Management Controls for Brokers or Dealers with Market Access, in its entirety.

Click **here** to read the SEC's Release No. 34-61345; File No. SR-NASDAQ-2008-104, Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Amendment Nos. 2 and 3 and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment Nos. 1, 2, and 3 Thereto, to Adopt a Modified Sponsored Access Rule.

[6] See Nasdaq Rule 4611(d)(5).

[7] Nasdaq states that at a minimum, the Sponsoring Member should receive immediate post-trade execution reports of trading activity of Sponsored Participants, including their identities, all required audit trail information, and all information necessary to create and maintain the trading records required by applicable regulatory requirements by no later than the end of the trading day. Supervisory personnel must review execution reports immediately and all other reports promptly.

Katten

Katten Muchin Rosenman LLP

www.kattenlaw.com

CHARLOTTE CHICAGO IRVING LONDON LOS ANGELES NEW YORK WASHINGTON, DC