

# Fortis Clearing

Elizabeth Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC  
20549-1090  
United States of America

Date 26 March 2010  
Subject **File No. S7-03-10 - Risk Management Controls for Brokers or Dealers with Market Access**

Dear Ms Murphy

Fortis Clearing, part of the Fortis Bank Nederland Group, ranks amongst the world leaders in global clearing, covering more than sixty equities, derivatives, commodities and energy exchanges in the world. We administer financial and non-financial, exchange-traded and OTC derivative products and offer settlement services for cash securities and derivatives from ten offices around the world. Amsterdam and London are the operational hubs for processing in Europe. In other time zones, we have operational centres in Chicago (the Americas) and in Sydney (Asia-Pacific).

To accommodate global clearing and custody and facilitate non-member business, market access to the world's major international derivative and stock exchanges is made available to clients that do not have a trading membership in their own name. Using some of the most up-to-date and fastest trading software available, from an array of third-party software vendors, we enable proprietary trading groups, brokers, trading bureaus and funds to gain market access from all over the globe.

As such, Fortis Clearing has deep interest in ensuring fair, open and efficient markets to enable our clients to participate fully in financial trading, meeting their own needs and providing liquidity to others. We appreciate the opportunity to comment on the Commission's proposed rules, and have addressed the questions raised throughout the paper in a structured and sequential manner, included in the Annex to this paper.

However, to summarise briefly our position on the proposed rules:

- We support the principle of reducing systemic risk from the financial system and of introducing appropriate controls to do so.
- We believe that the current proposals are a valuable initial step but do not recognise the multitude and complexity of different users in the market access field and the differing ways that their risks may be managed or mitigated.
- We believe that the proposed rules do not address the role the exchanges should play in providing proper controls over trading as they are structurally the most efficient and effective place for these, and further this would enhance the level playing field for all market participants.

We would be very happy to answer further questions or discuss our response with the Commission at your convenience.

Yours sincerely,



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## Annex - Risk Management Controls for Market Access

### QUESTIONS

1. The Commission seeks comment on all aspects of the proposed rule.

1.1. Does the proposed rule serve to appropriately and adequately mitigate the financial and regulatory risks associated with market access?

*We agree with the broad principles of the proposed rules that are directed at making a closer association between the manner of trading by market access and the consequential risks to the broader financial system. However we feel that the proposed rules are insufficiently focused to differentiate between the differing risk profiles associated with various types of market access, and will expand further on this in our responses below.*

1.2. If not, how should the Commission change the proposed rule to address these risks?

*We strongly believe that strengthening of the market infrastructure and operating practices should be made as a joint effort by market participants and the exchanges that provide the venue for trading activity. To place requirements solely on firms does not recognise the role that exchanges can play in destabilising markets and permitting sub-optimal activities.*

*The proposals also do not recognise that for certain controls the best place for these is at exchange level and not at individual firm level. The requirement for exchanges to maintain controls such as pre-trade risk filters or controls to prevent wash-trades has several benefits:*

- A level playing field amongst all market participants by ensuring that both large and small firms are offered the functionality of exchange-applied filters*
- Equal latency effects on trading activities, reducing certain aspects of regulatory competition between market participants*
- Economic efficiency by the avoidance of development and duplication of identical software and controls by multiple market participants*

*It is noted that regulatory interest is usually directed at preventative measures directed at firms and little emphasis is placed on the exchanges to provide a trading environment in which the occurrence of market damaging incidents, either deliberate or accidental, are reduced by design.*

*In a similar way in which firms compete between each other over the level of filtering that they apply to clients' transactions, exchanges have been known to engage in a form of regulatory arbitrage in enabling the broadest possible range of access standards in order to gain a competitive advantage.*

*Rules should be made to require exchanges to take equal responsibility for the efficient operation of financial markets.*

1.3. Should the Commission address other risks in its proposed rule?

*The Commission has stated that it intends to address Financial Risk and Regulatory Risk in its proposals. We do not believe that the proposals should be extended to address other forms of risk such as Legal Risk. However we would expect that in applying any proposed rules aspects that are specifically related to other forms of risk (for example, Credit or Operational Risk) are considered as part of maintaining an environment in which the proposed rules are applied.*

- 1.4. Should these risks be addressed with additional specific controls in the rule text?

*Yes, we believe that certain specific aspects should be addressed directly within the rule text.*

- 1.5. Are there other feasible alternatives that the Commission should consider in order to achieve the goals of the proposed rule?

*Yes. Please refer to our comments at 1.2 on the role of exchanges.*

- 1.6. Would the proposed rule affect trading volume?

*We believe that the rules would not significantly affect trading volumes either positively or negatively if the Commission were to work with other regulators in other jurisdictions in order to ensure that similar rules were implemented.*

*To the extent the rules were imposed by the SEC in a unilateral or more onerous manner than other jurisdictions and equivalent trading opportunities existed outside the US markets, it would be probable that a proportion of trading volume would be lost.*

- 1.7. If so, what impact would the proposed rule have on trading volume?

*We believe that the most significant loss of trading volume would be amongst the professional market participants and proprietary trading firms. This will in turn also have a negative effect on the retail investor volume by reducing overall market liquidity and increased market spreads on price, increasing the overall cost-of-trade to the end retail client.*

- 1.8. Would the proposed rule affect market quality? If so, what impact would the proposed rule have on market quality?

*We believe that the primary danger to market quality arises from structural changes in market participation. There is a danger that smaller and potentially lower-quality trading participants seek to enter the market directly, leading to an overall weakening of the market's control environment.*

*If the existing broker/dealers and General Clearing Members that offer market access to their clients are required to impose restrictions that are seen as excessive by clients, these clients may seek their own market memberships in order to be in direct control of their trading environment. This may result in a number of new market participants that are not as well-capitalised as existing members, that may have weaker systems and controls, and that may set lower standards for risk management that are below existing levels.*

*This would reduce the overall quality of the market. In drafting and applying the requirements, the Commission should take care to ensure that the limits do not restrict exchange members services to their clients so much that they actually cause more risk.*

- 1.9. Would the proposed rule impact trading volume or market quality differently in equities, options, fixed-income or other securities?

*Please explain response and provide any appropriate data.*

*Yes. For example, markets in options on any underlying instrument are very difficult to apply pre-trade risk limits too in a practical manner. The same numeric parameters cannot be applied to both at-the-money options and deep -out-of the-money options unless the potential price range is so wide as to be meaningless.*

*Each asset class will tend to have inherently different characteristics that make the application of "one size fits all" pre-trade risk filters extremely problematic. The Commission should consider what impact the proposals will have on each distinct asset class and whether, either individually or collectively the proposals represent an effective control.*

2. Under the proposed rule, market access means 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 proposed rule would apply equally to brokers or dealers with market access, whether they are proprietary traders, conduct traditional brokerage services, or provide direct market access or sponsored access.

- 2.1. Should the proposed rule apply to all types of market access similarly?

*Yes. The proposed rules must apply to all members of an exchange or ATS equally, and without regard to the whether they are proprietary or client-serving traders. Otherwise there is no level playing field and advantages in the execution of orders will flow to those members not obliged to apply risk-management controls. The proposed rules should not just be applicable to those members offering third party access.*

*Please note that this response should be read in the context that whilst we request that a level playing field is established for the application of the proposed rules to all exchange members, we believe that the proposals themselves should be adjusted to incorporate recognition of the differing business models and risk appetites of exchange members and their clients.*

- 2.2. Should market access arrangements be treated differently under the proposed rule depending on the type of market participants that are party to the arrangement?

*No. The same rules should be applied to all exchange members, although as noted in section 2.1 we believe that the rules should offer recognition of different business models.*

3. The proposed rule would require 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, to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks related to market access.

- 3.1. Generally, are there access arrangements that warrant different requirements? If so, please state which ones and why.

*No. The same rules should be applied to all exchange members.*

*To achieve this we believe that the preferred, and most efficient, model would be to have access arrangements governed and applied by exchanges and not by individual members.*

- 3.2. If a broker or dealer provides another broker or dealer with market access, should such an arrangement be treated differently under the proposed rule?

*In principle, we believe that different arrangements should be possible in this scenario.*

*The proposed rules should require that orders have to pass through only one set of pre trade risk management controls prior to execution on an exchange. It would be most appropriate if these controls were applied at the level of the final exchange member that interacts with the market, or at the exchange level itself.*

- 3.3. In this situation, should the proposed rule permit an allocation of responsibilities for implementing the appropriate financial and regulatory risk management controls between those brokers or dealers?

*Yes. However ultimate responsibility must rest with the exchange member(s) to ensure that the final order submitted to the market complies with applicable rules.*

*Any allocation of responsibility must be clearly documented and formally acknowledged by all of the parties involved to ensure that there is no omission from oversight of any requirement.*

- 3.4. If so, to what extent, and on what basis?

*It is a broadly accepted principle of regulation that whilst performance of an obligation may be delegated, responsibility for that obligation cannot. Therefore it should be possible to delegate to a third party, including a client broker/dealer, all operational aspects of compliance with the proposed rules but not the ultimate responsibility for compliance with the proposed rules.*

*In practice this should mean that the party to whom the rules apply directly must have procedures and monitoring in place on an ongoing basis to ensure that the proposed rules are followed.*

- 3.5. Should the Commission require broker-dealers that provide other persons with sponsored access to an exchange or ATS to have separate identifiers for each such person?

*Yes. It is difficult to see how effective supervision can be achieved without the use of separate identifiers to indicate the originator of a trade and the ultimate beneficiary of the resulting position.*

- 3.6. Are there any circumstances in which a broker-dealer ought not to be responsible for trading conducted by other persons under its MPID or otherwise?

*No. The principle of a level playing field should require all market participants to be treated equally in the application of the proposed rules. The market participant may then decide to delegate or out-source certain practical aspects of compliance with the rules to its clients or other third parties.*

*However as noted in 1.1 we believe that the drafting of the rules themselves should recognise the different characteristics of both products and clients.*

- 3.7. Should an ATS in its capacity as broker-dealer be required to implement appropriate risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks, such as legal and operational risks, associated with non-broker-dealer subscriber's access to its ATS?

*Yes. However our response is given from the position that the ATS should not be required to implement such controls and procedures arising from its capacity as a broker/dealer, but from its function in the financial system as a pseudo-exchange.*

*Thus the operator of an ATS should be expected to have the same control environment as any other recognised exchange and the same obligations to ensure equal access and proper security of the financial system. The use of ATS status should not lead to a regulatory arbitrage that permits preferential access and lower risk management requirements to those clients that use an ATS rather than route orders through a broker/dealer that is an exchange member.*

4. The proposed rule encompasses trading in all securities on an exchange or ATS.

4.1. Should the proposed rule apply equally to trading in all securities?

*Yes. We believe that all equity securities traded on an exchange or ATS should be treated equally.*

*However we believe that a different regime should be applied to the various forms of equity derivative, and in particular equity options as these have differing characteristics. The application of a securities-based set of parameters to different instruments will have unintended consequences.*

4.2. For example, should the Commission consider alternatives to the proposed rule in which trading in debt securities, equities, and options are treated differently?

*Yes. We strongly believe that alternative rules should be proposed to reflect the different asset classes and the different client needs and expectations of the various market participants.*

4.3. If so, to what extent and on what basis?

*We do not believe that it is appropriate as a regulated firm for us to set out our view of the full scope of intended rules. However the basis of the rules should be to recognise the different characteristics of trading activity (for example, proprietary position taking versus hedging trades) or the products themselves (for example, an in-the-money option versus an out-of-the-money option) and set appropriately different control parameters..*

5. Under the proposed rule, brokers or dealers would be required to implement controls that are reasonably designed to prevent the entry of orders that are not in compliance with financial controls and regulatory requirements and thereby effectively prohibit the practice of broker-dealers allowing for "unfiltered" or "naked" access to an exchange or ATS.

5.1. What are the benefits and costs to the securities markets associated with "unfiltered" or "naked" access to an exchange or ATS?

*There are numerous benefits to the use of unfiltered access (including the use of sponsored access) to participants in securities markets. Amongst these are:*

- Reduced latency giving more rapid and certain execution*
- Lower technology infrastructure costs*
- Avoidance of disclosure of order flow or trading intentions to a third party broker*

5.2. Specifically, what impact would effectively prohibiting "unfiltered" or "naked" access have on broker-dealers providing such access?

*On the broker-dealer it would have an impact on how it manages and controls pre-trade risk filters across multiple exchanges. In many cases it would require access to and familiarity with the proprietary software from the High Frequency Trading firms that require the access.*

*It would increase costs to market participants and be likely to start an expensive arms race in firms seeking to provide the lowest latency pre trade risk solutions. The alternative is that the ownership of satisfactory risk management measures is passed to the end user.*

*This may in turn generate jurisdictional issues as the end user may not be sufficiently linked to the exchange or regulatory system to make enforcement of such restrictions*

*practical. They would have to be enforced contractually with end users through client agreements, and again firms would be put in a position where regulatory arbitrage would be possible through setting and enforcing lower requirements than competitors.*

5.3. What impact would it have on the markets?

*The primary impact would be to push more entities to taking exchange memberships with the intention of controlling their own pre-trade risk infrastructure. This would be with a view to integrating any mandatory controls as closely as possible into their trading systems and reducing the overall latency in the execution cycle.*

*At the broader level of the entire market the increase in required exchange memberships would lead to more duplication of exchange infrastructure, to provide trading services. It would also serve to differentiate markets where such restrictions were in place from those where unfiltered access is still permitted, leading to changes in the balance of liquidity and trading patterns.*

5.4. What impact would it have on customers that use such access?

*Customers that use such unfiltered access are likely to be disincentivised to continue trading in the style that they previously have. This would be due to a combination of higher infrastructure costs, lower appetite to trade some markets with a downward spiral in liquidity available, and an overall longer time to market to develop trading strategies that works within a filtered environment..*

5.5. What percentage of volume is directed to the exchanges through "unfiltered" or "naked" access?

*Our estimate is that approximately 10% of exchange volumes are transmitted through "unfiltered" access.*

5.6. Should the Commission consider alternatives to a prohibition on "naked" access?

*A stronger alternative that a prohibition on member firms offering naked access would be to require co-ordinated exchange pre-trade risk management. In the current regulatory framework the exchanges do nothing and pass all responsibility to their members for preventing market abuse and financial risk. By requiring exchanges to implement pre-trade risk management it offers the possibility of a double layer of risk management as there would also be nothing to prevent an individual member firm adding its own controls to protect its own financial position, in addition to the exchange's measures.*

5.7. Would the proposed rule affect the way market participants use market access arrangements?

*Yes. Refer to 5.4.*

5.8. Are pre-trade controls the preferred method for adequately mitigating all the risks associated with market access?

*No. In the same way that there can be multiple forms of risk, there are an equivalent number of risk mitigation measures that can be taken. Examples of other forms of controls include:*

- post trade risk management*
- collateral management*

- *legal guarantees and contractual arrangements*
- *know your client procedures*
- *relevant examinations and trading qualifications*

5.9. Should the method for managing risk be particular to the specific risk?

*Yes. This is one of the primary reasons why we advocate a refinement of the proposed rules to distinguish between the different types of product and purposes for trading activity.*

5.10. Are there acceptable alternative modelling techniques that a broker-dealer may use to manage its financial and regulatory risks that would be functionally similar to the methods required by the rule? Please explain response and provide any appropriate data.

*The proposed rules seek to prevent market disruption by the use of pre-trade risk management measures. We believe that the objective of preventing defaults by participants can be equally well managed by effective post-trade risk management and strong collateral arrangements.*

5.11. Would the proposed rule affect the speed or efficiency of trading?

*Yes. For trades that are submitted via unfiltered access or where the existing filters are not the same as those required under the proposed rules there will be an effect. This will generally be negative on the efficiency of trading as it will introduce latency into the transmission and execution of orders.*

5.12. Would market participants be required to change their business models or practices in ways not contemplated by this release if the Commission were to adopt the proposed rule?

*Yes. This would involve a significant increase in the cost of technology required by market participants as they sought to offset the disadvantages of higher latency trading within the boundaries of the rules proposed.*

5.13. Would the proposed rule potentially impact competition among, or innovation by, market participants?

*Yes.*

5.14. If so, in what way?

*It is likely that the proposed rules would lead to an "arms race" in technology between brokers will ensue for the lowest latency pre-trade risk management tool to offer their clients. This will create much duplication of investment in systems, which is not beneficial to the overall health of the financial sector.*

*It may also lead to an increased risk of market incidents in the short term as firms develop and test their pre-trade risk management and clients become used to the limitations on their trading models that are consequently imposed.*

5.15. Which market participants would be impacted?

*The most significant impacts will be the second tier clients that mainly rely on third parties for hosting and provision of their infrastructure. These clients typically do not have the IT resources in-house to exploit rule changes in the most advantageous*



*manner and do not have the exchange memberships that permit them to take direct control over their risk management environment.*

5.16. Would such changes be beneficial or detrimental?

*If restrictions in the form of pre-trade risk parameters were applied by exchanges at a market-wide level then a level playing field that covers all forms of clients using market access would be maintained. Otherwise the changes would be detrimental in creating unequal market access between clients.*

5.17. Are there other internal or external costs not identified by the Commission that could result from the proposed rule?

*The Commission has considered that technology costs exist for market participants that are required to make the changes envisaged under the proposed rules. However we believe that the overall technology development, maintenance and staffing cost for a broker-dealer or GCM to run the kind of low latency efficient pre-trade risk management software required by clients is far higher than the Commission has identified.*

5.18. Which market participants are the most common or active users of sponsored access, generally, and "unfiltered" access, in particular?

*The typical user of sponsored access is the medium sized professional trading firm. Both High Frequency Trading firms and lower frequency trading firms that have a desire to keep the costs of trading down and or to enter markets faster and with more flexibility than they may be able to if they took their own memberships and built and maintained their own IT infrastructure.*

5.19. How many small broker-dealers have or use sponsored access arrangements?

*In our experience a sizeable proportion of small broker-dealers use sponsored access to offer a broader range of markets to their clients or traders. It is not possible for a single firm to offer an overall view of the market full market as we do not see arrangements of other market participants.*

6. The proposed rule would require broker-dealers with market access to implement risk management controls and supervisory procedures that prevent the entry of orders that, among other things, exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer, exceed appropriate price or size parameters on an order-by-order basis or over a short period of time, are indicative of duplicative orders, are not in compliance with a regulatory requirement that must be satisfied on a pre-order entry basis, or that is for a security that a broker or dealer, customer, or other person is restricted from trading.

6.1. Should the Commission include additional financial and regulatory risk management controls in the proposed rule?

*It is our view that it should be left to individual firms that provide market access to decide on the appropriate level of financial control over clients. This enables firms to match their criteria to their own risk appetite and the nature of their client base.*

*Regulatory controls may be appropriate to control access in certain ways but should be implemented in a manner to ensure that it is efficient and appropriately targeted.*

- 6.2. If so, what additional financial and regulatory risk management controls should be included?

*We would expect exchanges to be required to participate in ensuring that regulatory restrictions are applied consistently and efficiently.*

- 6.3. Would the additional standards apply to all brokers or dealers, or to a subset?

*There has to be a level playing field and this requires that the additional standards are applied to all broker-dealers equally.*

- 6.4. Conversely, if there are too many financial and regulatory standards, which ones are unnecessary?

*We do not believe that this is an appropriate place to comment on the more broad aspects of the nature of the regulatory regime that the Commission enforces.*

- 6.5. Would these standards be unnecessary for all parties, or should they still apply in certain specific cases?

*In order to maintain a level playing field between all market participants the proposed rules should be applied equally to all market participants.*

*However this should not be taken as unconditional support for the proposed rules in their current form as we believe that there needs to be an informed review of the requirements to ensure that broker-dealers have flexibility to implement the proposed rules in a manner that is appropriate for their particular clients, and the risk profile arising from those clients.*

- 6.6. Should the Commission specify more precise details regarding the financial and regulatory risk management controls?

*We believe that the Commission should not seek to micro-manage the risk management controls that it requires from broker-dealers offering market access. However the Commission should be very clear about the overall objectives and results that it is trying to achieve.*

- 6.7. Should the proposed rule specify financial and regulatory risk management controls that would apply after an order has been entered on exchange or ATS?

*The proposed rules should specify clearly the expectations on exchanges to maintain orderly markets, and where this requires controls after an order has been submitted but before it has been executed, these requirements should be clearly stated.*

*For example, exchange should be required to implement controls that prevent the execution of "wash" trades even if these have been inadvertently submitted by market participants. In this way the exchange improves the overall quality of the market rather than simply monitoring for such activity and taking disciplinary action after the fact.*

7. The proposed rule would require broker-dealers to establish an appropriate credit threshold for each customer. The Commission expects that broker-dealers would establish such threshold based on appropriate due diligence as to the customer's business, financial condition, trading patterns, and other matters, and document that decision.

- 7.1. Should the criteria for determining the appropriate threshold be explicitly listed in the proposed rule?

*Yes, if the Commission believes that there are common criteria that should be applied to customer's dealings, then these should be clearly stated in order for them to be applied consistently by all exchange members.*

- 7.2. Are there specific factors broker-dealers should consider in conducting due diligence?

*In conducting due diligence on clients, broker-dealers particularly take into consideration their historical experience of the particular client, the client-sector and their trading activities. These factors enable the firm to consider suitable risk parameters and collateral requirements.*

*It also informs the broker-dealer on the nature of its own post-trade monitoring capability that would be required to process this business activity. If reliance is to be placed on pre-trade capability then the whole risk management assessment will change and will be driven much more by an analysis of the technology used by clients and how it can be used without distorting the client's trading activities.*

- 7.3. Should the proposed rule require broker-dealers to establish "early warning" credit or capital thresholds to alert them and their customers when the firm limits are being approached, so there is an opportunity to adjust trading behaviour?

*We believe that the role of early warning or pre-incident risk management is essential in any system intended to manage risk successfully. As such, we do not believe that a requirement of this type will be a significant burden on properly organised and managed firms.*

*However such a requirement must not be viewed in isolation with a particular activity, and should give flexibility to consider all aspects of a client's trading. This proposal would be acceptable as long as the big picture of the client's overall exposure to the broker-dealer is taken into consideration and not just limited to the transactions on the exchange where market access exists.*

- 7.4. Should the proposed rule require a broker-dealer to establish an aggregate credit threshold for all of its customers?

*Yes. We would expect this to be in place already for any well-managed firm offering market access.*

- 7.5. Should the Commission provide additional guidance on the short period of time in the prevention of entering erroneous orders requirement?

*Yes. We again emphasise that this is the form of restriction that is best applied at a market-wide level and if possible through the medium of the exchange systems that are providing the market access.*

- 7.6. Is there a common understanding among market participants regarding the timeframe used to prevent the entry of erroneous orders?

*No, there is not.*

8. The proposed rule would require broker-dealers with market access to implement risk management controls and supervisory procedures that are reasonably designed to restrict access to trading systems and technology that provide market access to permit

access only to persons and accounts pre-approved and authorized by the broker-dealer.

- 8.1. Could the goal of this provision, the preservation of system and market integrity, be achieved in another way?

Yes.

- 8.2. If so, how?

*By setting standards for regulation and risk management controls that could be delegated to the client for operational purposes whilst remaining the responsibility of the broker-dealer who would also be expected to oversee ongoing compliance with them.*

9. The proposed rule would require broker-dealers with market access to implement risk management controls and supervisory procedures that are reasonably designed to ensure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.

- 9.1. Should the Commission expand on or clarify the requirement that risk management controls and supervisory procedures be reasonably designed to assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access?

*Yes. The Commission should clarify its expectations of firms by explaining what action is required and how it is to be administered. In our experience there is much difference in effect between receiving a report and actually knowing what to do with it.*

- 9.2. Is there a common understanding among market participants as to what constitutes immediate post-trade execution reports?

*No, our experience suggests that at the current time this does not exist.*

10. The Commission seeks comment on whether broker-dealers could effectively comply with the proposed rule – in particular, the requirement that the financial and regulatory risk management controls and supervisory procedures be under the direct and exclusive control of the broker-dealer with market access – by using risk management technology developed by third parties.

- 10.1. Are there any circumstances where a broker or dealer would not be able to comply with the proposed rule using risk management technology developed by third parties?

*In technical terms it may be possible to implement controls as proposed for all forms of customer. However, to do so may destroy the business model for the market access arrangements. This is particularly true when dealing with orders from brokers or options traders. These would require complex, and hence lengthy, calculations in order to assess the overall risk in executing a single trade. As a consequence this may result in the trading opportunity being missed.*

- 10.2. Are there additional considerations that the Commission should evaluate if a broker-dealer outsources the development of its risk management system and supervisory procedures?

*The requirements for the risk management system have to be clearly defined, what limits are acceptable and sufficient, and what action the outsourcing provider has to take if an issue arises.*

11. The proposed rule would require the broker-dealer to periodically review its risk management controls and supervisory procedures. Among other things, the broker-dealer would be required to review in accordance with written procedures, and document that review, no less frequently than annually, its business activity in connection with market access to assure the overall effectiveness of such risk management controls and supervisory procedures.

- 11.1. Should this review be conducted more or less frequently?

*We believe that to conduct such a review annually is sufficient to. The review itself represents only a formalisation of the exercise that should be conducted on an ongoing basis to ensure that a firm controls its risks adequately at all times.*

12. In addition, the Chief Executive Officer (or equivalent officer) of the broker-dealer would be required, on an annual basis, to certify that such risk management controls and supervisory procedures comply with paragraphs (b) and (c) and that the regular review was conducted.

- 12.1. Should the certification be conducted more or less frequently?

*An annual certification is sufficient.*

13. The proposed rule would require a broker or dealer to preserve a copy of its supervisory procedures, a written description of its risk management controls, and written supervisory procedures for its regular review as part of its books and records in a manner consistent with Rule 17a-4(e)(7).

- 13.1. Is this proposed record retention requirement clear?

*Yes.*

14. The proposed rule would require documentation of each regular review and Chief Executive Officer certifications be preserved by the broker or dealer as part of its books and records in a manner consistent with Rule 17a-4(b).

- 14.1. Is this proposed record retention requirement clear?

*Yes.*

15. The Commission seeks comment on the anticipated benefits of the proposed rule, including the following:

- 15.1. Would the proposed rule provide market benefits that the Commission has not discussed?

*We have not identified any benefits above those expected by the Commission.*

- 15.2. Would the proposed rule help level the playing field for broker-dealer competition?

*We believe that the proposed rules will only help level the playing field in market access if exchange members that trade using their own membership of an exchange are required to implement equivalent pre-trade risk controls.*

- 15.3. Would the proposed rule serve to reduce systemic risks to the US markets?

*To the extent that the absence of pre-trade risk controls poses a systematic risk to the US markets these proposed rules will serve to reduce it. However more effective controls over systemic risk could be achieved through other approaches such as real time risk management or increased client profiling.*

15.4. Would the proposed rule serve to promote trading volumes?

*It is difficult to see how the proposed rules would promote an increased volume of trading. There may be a certain increase in orders from retail clients if they perceive the markets to be less populated by professional trading firms. However this is unlikely to offset the amount of decreased liquidity from slowed or deterred orders from professional traders and high-frequency trading firms.*

15.5. Would the proposed rule enhance market integrity, promote investor protection, and protect the public interest?

*Other than by perception it is unlikely that these measures alone will have a significant effect on the market integrity and protection of the public interest as they are targeted towards systematic risk and not investor protection.*

16. Based on discussions with industry participants, the Commission is aware that, if the Commission were to adopt the proposed rule, there is a potential for latency, ranging approximately from 200 to 500 microseconds, for orders that currently route to exchanges or ATSs via "naked" access arrangements. The Commission however preliminarily believes that the potential costs associated with the elimination of "unfiltered" access, including the potential for latency, are justified by the overall benefit to the U.S. markets. We solicit comment on the Commission's view.

16.1. Would the controls imposed by the rule substantially increase latency?

*They will undoubtedly increase latency, as would any action that interferes with the direct passing of an order from the trader's terminal to the exchange. However the exact quantum of the delay will depend upon the number and nature of the required checks, and the technical implementation of the checking filters.*

16.2. To what extent would broker-dealers have greater incentives to reduce any such latency?

*The broker-dealers would have an incentive to reduce latency in order to gain an advantage in marketing their execution services to clients such as high frequency trading that depend on immediate market access and execution.*

16.3. Would broker-dealers incur additional costs in reducing any such latency?

*Each effort to reduce latency within a given regulatory parameter incurs a definite cost on a broker-dealer. The amount and extent of these costs will depend on the reduction in latency that a client is seeking.*

16.4. What would be the costs to market participants of any additional latency?

*The costs to market participants as the end-clients would initially be in lost trading opportunities, and increased frictional costs. Should users of market access seek to gain their own exchange memberships in order to circumnavigate the controls over sponsored links they will incur costs of establishing their own technology infrastructure and staffing levels, as well as the additional costs of software development and licensing.*

16.5. Can these costs be quantified?

*It is extremely difficult to quantify these incremental costs as they will vary depending on the activities of the particular market participant, what activities they do and what solutions they would implement to meet the effects of the proposed rules.*

17. The Commission is also aware that some broker-dealers may benefit from offering sponsored access because they receive volume discounts offered by exchanges and other market centres due to the trades entered under the broker-dealer's MPID or otherwise.

17.1. How much would the proposed rules affect the volume discounts enjoyed by broker-dealers?

*The impact of the proposed rules in financial terms could be significant to individual broker-dealers. The precise effect will depend on the nature of the scheme for each individual exchange, and particularly the way in which they may aggregate trading volume for the purpose of incentive calculations.*

17.2. Would this effect differ across broker-dealers?

*Yes, depending on the existing way in which incentive schemes are utilised by individual firms. An unanticipated impact of the loss of volume discounts will be an increase in costs to the end customer when broker-dealers pass on, or split, the rebates that they have earned with their clients.*

17.3. What characteristics impact a broker-dealer's reliance on sponsored access for these volume discounts?

*The characteristics will vary from market to market, and from incentive scheme to incentive scheme, although the incentives may be considerable in order to lower the overall costs of trading where these discounts are offered*

17.4. How would any effect alter a broker-dealer's business?

*The proposed rules would lose the efficiencies of bundling different clients onto single shared infrastructures to achieve cost benefits to those firms and clients that participate in such structures.*

17.5. Can any such costs be quantified?

*Given the individual nature of these schemes it is difficult to quantify the overall benefits that would be lost.*

18. The Commission seeks comment on any other potential costs to brokers or dealers that may result from the proposed rule. While the Commission does not anticipate that there would be significant adverse consequences to a broker or dealer's business, activities, or financial condition as a result of the proposed rule, it seeks commenters' views regarding the possibility of any such impact.

18.1. For instance, would the proposed rule impact a broker or dealer's ability to attract or retain its market access customers?

Yes.

- 18.2. Could a broker or dealer lose order flow, because its customer might seek other arrangements in order to access the securities markets, such as becoming a member of a particular exchange or becoming a broker or dealer?

Yes.

19. The Commission also requests comment on the following:

- 19.1. Would the proposed rule impair the ability of market participants that currently rely on "unfiltered" access to compete?

*Yes. They would be at a disadvantage to exchange members that may not have to comply with such order flow restrictions. This is despite the fact that certain High Frequency Trading and proprietary firms may have more advanced technology and trading systems, and they may actually have better risk controls in place than a typical exchange member itself.*

- 19.2. Would the proposed rule have any unintended, negative consequences for the U.S. markets?

*Yes, cost of trading to clients of exchange members will rise and the ease of entry to markets would be hindered. The proposed rules are likely to lead to an increased concentration of firms providing market access, reducing the available choice for end-clients.*

- 19.3. Would the proposed rule decrease the propensity of market participants that currently rely on "unfiltered" access to provide liquidity to the U.S. markets?

Yes.

- 19.4. Would the proposed rule stifle or impact certain trading strategies that may add value to the market?

*Yes, to the extent that any restriction in traded volumes may reduce the liquidity, both in single trades and in strategies quoted to participants, that are available.*

- 19.5. Would the proposed rule limit price discovery mechanisms?

*No, although it may reduce its effectiveness. Price discovery would still be possible. However fewer market participants may lead to less depth of liquidity and wider bid-offer spreads.*

20. We request comment on the following questions:

- 20.1. Would the Proposed Rule 15c3-5 modify the competition among market centres and broker-dealers to obtain members or offer sponsored access?

Yes.

- 20.2. What are the benefits of being a member or subscriber to a market centre that would not be available to someone with sponsored access or direct market access?

*This would depend on the implementation of the proposed rules that would cover non-naked access via third parties, such as the requirements set on what is effectively naked access but using a firm's own exchange membership.*



*The advantages are clear in situations in which a particular structure to access the market for execution results in an extra layer of risk management being put in place.*

- 20.3. Would the proposed rule increase or decrease the propensity of broker-dealers and others to become members or subscribers?

*The proposed rules are likely to increase the propensity of market participants to become exchange members if this offered a more direct means of executing their orders compared to the use of a third-party broker to route their orders to the market. As has already been noted, an unequal implementation of risk management controls will lead to participants choosing routes that compete on latency criteria, as well as conventional risk management and commercial pricing criteria.*

- 20.4. Would the proposed rule increase or decrease the propensity of non-broker-dealer market participants to register to become broker-dealers?

*If the proposed rules permit a more relaxed regulatory regime for broker-dealers it would be expected that there will be an increase as participants adjust their structure in order to try and avoid the negative effects of intrusive regulation on sponsored access.*

- 20.5. How would the proposed rule affect overall access to markets? Would the proposed rule affect any other type of competition between market centres?

*Not would if there was no level playing field say for example between ECN's and the incumbent exchanges*

- 20.6. How would Proposed Rule 15c3-5 affect price efficiency?

*This proposal will only affect price efficiency as far as it has a negative impact on liquidity. With a loss of liquidity there will be a consequential impact on price efficiency.*

- 20.7. Would pre-trade reviews limit unlawful or erroneous trading? To what extent would limits on erroneous trading improve price efficiency?

*There would be a beneficial effect on unlawful or erroneous trading if the pre-trade limits were correctly set. However this is a matter where we return to the theme of our earlier comments that setting parameters to capture the individual risks from specific clients, activities and trading strategies requires significant expertise to implement correctly without impacting on market efficiency.*

- 20.8. To what extent would the pre-trade reviews reveal other trading that could affect price efficiency?

*We do not believe that pre-trade review would in isolation reveal other factors affecting price efficiency in the limited time that they could be performed.*

- 20.9. To what extent would the controls imposed by the rule create latency that can slow the incorporation of information into prices?

*It is difficult to quantify this effect in terms of milliseconds. We would emphasise that rather than concentrate on the absolute value of latency, the Commission should direct its efforts to ensuring that participants are not discriminated against by arrangements that create differentials in the latency depending on their structure of*

*transactions. For this reason we prefer these controls to be driven as requirements on exchanges providing electronic access rather than individual firms themselves.*

- 20.10. To what extent would broker-dealers have greater incentives to reduce any such latency?

*The primary incentive for broker-dealers to reduce latency arising from pre-trade limits is competition from other firms. Unless the Commission takes care over the drafting and implementation of any proposed rules then firms will seek to compete on the their interpretation of the rules to give greatest possible advantage to their clients.*

## TECHNOLOGY QUESTIONS

21. The Commission seeks comment on the reporting and recordkeeping collection of information burdens associated with the proposed rule. In particular:

- 21.1. How many broker-dealers would incur collection of information burdens if the proposed rule were adopted by the Commission?

*In order for there to be a level playing field we would expect the burden of information gathering to fall on all firms equally.*

- 21.2. What are the burdens, both initial and annual, that a broker-dealer would incur for programming, expanding systems capacity, establishing compliance programs, and maintaining post-trade reporting if the Commission were to adopt the proposed rule?

*At this point it is difficult to quantify the burden, both initial and ongoing, but we feel that it would be considerable.*

- 21.3. Would there be additional burdens associated with the collection of information under this proposed rule?

*Yes.*

- 21.4. How much work would it take for brokers or dealers with existing risk management control systems and supervisory procedures to comply with the proposed rule?

*For firms that currently provide naked access to their clients the amount and cost of the work involved will be significant. There will also be an impact on clients that are using naked access as they will have to re-formulate their trading and risk-management models in order to conform with the new market access requirements and changed visibility and latency in the market.*

- 21.5. Would brokers or dealers generally perform the work internally or outsource the work?

*We would expect that Third Party software would be more widely used.*

- 21.6. What would be the hardware and software costs for brokers or dealers that complete the work internally?

*We would expect that the costs of developing an individual in-house solution would be considerably more than the purchase of a third party solution. Thus a further effect of the proposed rules will be to create additional business opportunities for the providers of risk-management software.*

21.7. What about those that outsource the work?

*Reliance will need to be placed on the service provider to provide accurate costing.  
This will also depend on the model adopted, and whether it is maintained in-house or  
hosted externally.*