



April 16, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Exchange Act Release No. 61379; File No. S7-03-10; Risk
Management Controls for Brokers or Dealers with Market Access

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to comment on Securities Exchange Act (“Exchange Act”) Release No. 61379, in which the Securities and Exchange Commission (the “SEC” or “Commission”) requested comment on a proposal to adopt a rule requiring risk management controls for broker-dealers with market access (the “Proposal”). The Proposal would require broker-dealers with access to trade directly on an exchange or an alternative trading system (“ATS”) to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity.

I. Introduction

In broad terms, the Proposal to adopt new Exchange Act Rule 15c3-5 would require broker-dealers that provide sponsored or direct market access to customers or other persons to manage the financial, regulatory, and other risks of providing such access to exchanges and ATSs. The Proposal would require pre-trade controls and supervisory procedures to be under the “direct and exclusive” control

¹ The Securities Industry and Financial Markets Association (“SIFMA”) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA’s mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (“GFMA”). For more information, visit www.sifma.org.

of the sponsoring broker-dealer, even if provided through a vendor system. These controls and procedures are required to be applied on an automated, pre-trade basis before orders are routed to an exchange or ATS. Thus, the Proposal would, as the proposing release notes, effectively prohibit the practice of what has become known as “unfiltered” or “naked” access.

SIFMA supports the general principle underlying the Proposal that pre-trade and post-trade controls and procedures are appropriate in sponsored access arrangements.² The Proposal creates a consistent standard for these pre-trade and post-trade controls across markets. SIFMA believes that a uniform requirement for such controls and procedures is useful in mitigating the systemic risks that sponsored access can potentially present. In addition, SIFMA supports the policies and procedures approach of the Proposal.

SIFMA, however, believes the rule should not be adopted until significant complex issues are addressed. In particular, the Proposal’s simple structure raises complex issues regarding its application to well-established industry practices, which do not themselves involve heightened systemic risk concerns. These issues include:

- the application of the Proposal to situations where multiple broker-dealers are involved in routing an order to a market center (such as an introducing broker, clearing broker, executing broker, routing broker, inter-dealer broker, and floor broker);
- the treatment under the Proposal of third-party risk management software, including risk management software that is offered by market centers (which is commonly used today);
- the role of market centers in monitoring compliance with the proposed rule;
- the proposed rule’s treatment of certain regulatory concerns, such as insider trading, market manipulation, and margin rules; and
- that the Proposal would not apply to non-exchange and non-ATS venues.

² In this letter, the term “pre-trade” refers to the period of time prior to and including order entry, as well as the period of time during which an order has been entered but has not yet been executed (*i.e.*, open orders); “post-trade” refers to the period of time after an order is executed.

There also are additional significant operational and compliance considerations that the SEC should consider as it contemplates a final rule. SIFMA believes that it is critical to resolve these issues in a workable manner before considering moving forward with the Proposal.

II. Multiple Broker-Dealer Roles

Given the operational nature of the rule and that multiple broker-dealers may play various roles in executing a transaction, the Proposal presents complications that the Commission should consider. For example, many trading arrangements involve several broker-dealers, each of whom undertakes a different role in the transaction.

Specific examples of situations where multiple broker-dealers are involved in executing an order include:

- an introducing broker-dealer routes its customer orders to an exchange through an access broker-dealer and clears through a separate clearing broker;
- a clearing firm provides order entry systems to introducing firms for use by the introducing firm's investment professionals, home office or retail investors;
- an executing broker for a hedge fund uses a broker-dealer to access an ATS and clears the trade through a separate prime broker;
- a broker-dealer uses another broker-dealer for access to exchanges of which it is not a member for its own proprietary and institutional customer accounts;
- a broker-dealer uses a smart order router or algorithm provided by another broker-dealer;
- a NYSE member gives an order to a NYSE floor broker for execution; and
- a retail broker routes orders to options markets through consolidators.

In each of the examples noted above, we assume that only the broker-dealer whose identifier is used to provide access to an exchange or ATS would be directly subject to the rule. Applying the rule to *all* of the broker-dealers involved

in the execution and clearing of a transaction, some of whom may have a limited role, would be unnecessary and duplicative.

As a threshold matter, responsibility for compliance with the market access rule should be the obligation of the broker-dealer providing access to an exchange or ATS rather than an obligation of all the broker-dealer participants in the transaction. However, in certain circumstances the broker-dealer providing access may not be in the best position to control financial and regulatory risks associated with transactions for other broker-dealers or customers, and financial and regulatory controls may already be assumed by other broker-dealers involved in the transaction. It may be redundant or, in some cases, extremely impractical to require the broker-dealer providing access to apply all of the required pre- and post-trade controls and procedures to each order.

SIFMA believes that the rule should allow the broker-dealer providing market access to reasonably rely on the risk procedures operated by another broker-dealer in the transaction in particular situations where that other broker-dealer is in a better position to carry out these procedures. In these situations, the broker-dealer providing market access should have its own procedures to support such reliance, which could include receiving representations and warranties from the broker-dealer on which it is relying and annually recertifying the arrangement as a part of renewing access arrangements. In this way, the broker-dealer with the most effective access to the information required by the Proposal, and with the most effective ability to control the risk presented by a given order, would be able to use that information and take the steps necessary to mitigate risk.

Some SIFMA members believe that a broker-dealer should be free to determine which broker-dealer is best positioned to apply the required risk procedures.³ Other SIFMA members believe that the rule should specifically allocate responsibility for risk management controls and procedures to executing and clearing broker-dealers based on the executing and clearing broker-dealers' access to information and the role that each plays in the trading process. These allocations would take into account which controls and procedures are appropriate on a pre-trade basis and post-trade basis, and would allocate pre-trade, order-

³ This approach would be consistent with NYSE Rule 382 and NASD Rule 3230, which require broker-dealers providing brokerage services to customers pursuant to an agreement to allocate responsibilities between themselves based on an assessment of which broker-dealer is best positioned to carry out a particular function. The approach also would be similar to Rule 203(b) of Regulation SHO which provides an exception from the locate requirement if a broker-dealer receives a short sale order from another broker-dealer that is required to comply with the locate requirement.

based controls to the broker-dealer providing access and post-trade credit controls to the clearing firm.

As the Commission studies the effect the Proposal would have on various common trading arrangements, SIFMA would be happy to discuss the alternatives outlined above with the Commission or its staff.⁴ Indeed, we believe that it is critical for the Commission to consider the operational challenges presented by the Proposal before implementing a final rule in order to avoid unintended consequences and to ensure that the new rule mitigates the systemic risk concerns that the Proposal is intended to address.

III. “Direct and Exclusive” Control Requirement and the Use of Third Party Software

The Proposal requires that the financial and regulatory risk management controls and supervisory procedures be under the “direct and exclusive” control of the broker-dealer that is providing market access. The proposing release states that broker-dealers “would have the flexibility to seek out risk management technology developed by third parties, but the Commission expects that the third parties would be independent of customers provided with market access.”⁵ Given that many broker-dealers rely on such third party software that is often under the control of a third party vendor, the Commission should clarify that the underlying software can, in fact, be under the control of a third party vendor, provided that the broker-dealer is able to control the parameters and thresholds applied by the software. In addition, the Commission should clarify that software provided by exchanges and ATs could be one of the tools a broker-dealer could use to satisfy its control or surveillance obligations, assuming the broker-dealer can control the parameters of such software.

The Commission could assist firms in understanding the contours of the “direct and exclusive” control requirement by providing a non-exclusive list of examples

⁴ We also note that various SIFMA member firms are submitting their own comment letters on the Proposal, which will discuss more fully the alternatives outlined above and variations on these alternatives.

⁵ The SEC should clarify that the term “independent” refers to a third party vendor that is not a controlled affiliate of a customer to which a broker-dealer provides sponsored access. In other words, SIFMA does not believe that non-controlled-affiliates should be excluded from providing third party software.

In addition, the proposing release states that “independence” would be expected. The SEC should clarify that independence is required.

where the SEC would and would not consider third party arrangements to satisfy the rule.

IV. The Role of Market Centers in Applying Controls and Procedures

As noted above, many market participants rely on risk management software provided by exchanges and ATSS. One of the reasons that market participants do so is that market centers in many instances are particularly well-suited to apply pre-trade controls to order flow. For example, orders not reasonably related to the market, trading halts, and clearly erroneous orders could be monitored by a market center.⁶ Where such controls do exist at the market center level, the Commission should clarify that they can be relied upon by broker-dealers providing market access. Market centers may be less able to monitor for other standards, such as credit limits; therefore, it is appropriate for broker-dealers to monitor these standards without use of a market center's systems.

V. Application of Regulatory Controls Requirement / Timing of Surveillance Reviews

The Proposal requires risk management controls and procedures to be reasonably designed to ensure compliance "with all regulatory requirements." "Regulatory requirements" is defined broadly to include "all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access." As proposed, the rule could conceivably be interpreted to require a firm providing market access to have controls and procedures reasonably designed to prevent the entry of orders that are manipulative or are based on inside information, as the rule requires controls and procedures reasonably designed to "ensure compliance with all regulatory requirements."⁷ The SEC should clarify in the adopting release that broker-dealers providing market access would not be liable for regulatory requirements that are only tangentially related to accessing the market, such as margin requirements, or violative behavior that depends on the intent of the sponsored customer.

⁶ SIFMA notes that erroneous order policies in options are not consistent across exchanges, and therefore controls would be difficult to program / identify on a pre-trade basis. The SEC should encourage exchanges to develop consistent methodologies for identifying and implementing erroneous order policies.

⁷ The order approving amendments to Nasdaq Rule 4611, approved on January 13, 2010, notes that the rule requires monitoring of "illegal activity such as market manipulation or insider trading." Exchange Act Release No. 61345 (January 12, 2010). SIFMA notes that this requirement raises the same issues discussed in this letter.

In addition, SIFMA notes that surveillance for market manipulation and other fraudulent activity is really only possible on a post-trade basis. Insider trading, for example, can only be detected after the relevant inside information is made public. The Commission should make clear that monitoring for insider trading is not required by the Proposal. In addition, effective monitoring and surveillance of trading activities requires a view across trading venues, which a sponsoring broker-dealer may not have for a particular customer. Moreover, manipulative patterns generally require a view of a range of trading. For this reason, most broker-dealers do not routinely monitor for manipulative trading on a real-time basis. Thus, the SEC should confirm that firms would be in compliance with the rule by monitoring for manipulative activity on a delayed (*e.g.*, T+1) post-trade basis. Of course, a provider of market access should not be permitted to ignore behavior or a pattern of activity that is obviously violative.

In addition, the Proposal requires that a broker-dealer's market access controls and procedures assure that appropriate surveillance personnel receive immediate post-trade execution reports. Many firms already have systems and procedures in place for post-trade data to be reviewed on a T+1 basis, for the reasons that are discussed above. For purposes of clarity, the SEC should clarify in the adopting release that this requirement could be satisfied by using a broker-dealer's existing surveillance infrastructure, *i.e.*, there does not need to be a distinct surveillance team dedicated to reviewing market access information.

VI. Application of the Rule to Non-Exchange and Non-ATS venues

The Proposal applies to "market access," defined as "access to trading in securities on ***an exchange or alternative trading system . . .***" (emphasis added). Thus, the Proposal does not cover access to execution venues that are not exchanges or ATSs, such as over-the-counter market makers and other "upstairs" trading. Nor does the Proposal cover access to an ATS that is provided directly to subscribers by the ATS itself. The Commission should clarify that nothing in the Proposal would preclude the continued application of self-regulatory organization guidance that requires broker-dealers to apply risk controls and procedures to orders that are sent to non-exchange and non-ATS trading venues or to internal ATS venues. For example, NASD Notice to Members 04-66 reminds member firms that enter, or permit customers or non-FINRA members to enter, orders into the handling, routing, and execution services of a vendor, automated trading system, electronic communications network, or other market center "to take steps to ensure that such orders are free of errors and representative of bona fide transaction and quotation activity" and that they must have in place "supervisory systems and written supervisory procedures" with respect to order accuracy,

preset credit and order-size parameters, among other things. This guidance should continue to apply to avoid creating a significant regulatory gap.

VII. Additional Significant Operational and Compliance Concerns

In addition to the concerns discussed above, the Proposal would benefit from clarification regarding the application of capital and credit thresholds, duplicative orders, the Chief Executive Officer (“CEO”) certification requirement, and compliance exams that review a firm’s compliance with the rule.

A. Capital and Credit Thresholds

The SEC should clarify several matters with respect to capital and credit thresholds, including that:

- under the rule, firms would have the flexibility to make intraday exceptions to any established thresholds based on changes in market or customer conditions;
- the rule would require limits to be set at the broker level, *i.e.*, a clearing firm would look at the introducing broker, not the client of the introducing broker;
- there are situations where thresholds may not be appropriate, such as:
 - where there are sufficient assets on account to mitigate any market exposure in light of the client’s trading;
 - where executing broker accounts settle at prime brokers and the prime broker is extending credit;
 - where retail or institutional brokerages execute trades on an agency basis for many accounts, which makes it impossible and impractical to establish a “credit or capital threshold” as neither the sponsored party’s credit or capital, or for that matter the assets of any individual investor, is a risk mitigator as trading is being conducted for many investors; and
- it would be a reasonable procedure for a broker-dealer to set thresholds with reference to the aggregate market access that the broker-dealer provides, as broker-dealers are often not aware of a sponsored participant’s activity through other broker-dealers.

B. Duplicate Orders

The Proposal indicates that a broker-dealer that provides market access would be obligated to monitor for, and prevent the entry of, orders that indicate duplicative orders. Determining which orders are duplicative would be difficult to achieve, especially when the typical behavior for many clients is to trade in small order sizes. Requiring potentially duplicative orders to be rejected could result in a disadvantageous execution for a client if the order is indeed not duplicative. While we recognize that certain monitoring protocols can be implemented, such as checking whether client orders are being sent with the same ID, there should not be a requirement to prevent or reject these orders as clients may recycle order IDs intra-day. Thus, the Commission in the adopting release for the rule should recognize the difficulty and limits in monitoring for duplicate orders.

C. CEO Certification

The Proposal requires a sponsoring broker-dealer to review annually the business activity of market access to assure the overall effectiveness of the firm's risk management controls and supervisory procedures. A firm's CEO (or equivalent officer) is required to certify annually that the firm's risk management controls and supervisory procedures comply with the rule, and that the firm has conducted the required annual review and assessment. The SEC should clarify that the CEO certification could be completed as a part of existing review and certification processes, such as the FINRA Rule 3130 certification. That is, the adopting release should note that the same process and certificate used for FINRA Rule 3130 certifications could be used to satisfy the Rule 15c3-5 requirement.

D. Compliance and Exams

In the adopting release, the SEC should make clear that, in light of the policies and procedures approach of the rule, the SEC and other self-regulatory organizations should examine firms with a view toward improving procedures, as opposed to taking the view that any trading error is per se a violation of the rule.

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As stated above, we believe that the Proposal presents complex issues that are not addressed by the Proposal in its present form. These complexities should be addressed prior to adoption of a final rule. We support the principles underlying the Proposal, and believe that our above comments and suggestions, if reflected in the final rule, would serve to strengthen the rule and further the goals of maintaining market integrity and mitigating systemic risk.

We would be pleased to discuss these comments in greater detail with the Commission and its staff. If you have any comments or questions, please do not hesitate to contact me at 202.962.7300.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Ann L. Vlcek".

Ann Vlcek
Managing Director and Associate
General Counsel
SIFMA

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
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Robert W. Cook, Director, Division of Trading and Markets
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