
SEC Staff Issues First Set of FAQs on Rule 15c3-5, Risk Management Controls for Brokers or Dealers with Market Access

TUESDAY, APRIL 22, 2014

On April 15, 2014, the Staff of the SEC's Division of Trading and Markets issued its first set of frequently asked questions (FAQs) regarding Rule 15c3-5 under the Securities Exchange Act of 1934.¹ Rule 15c3-5 (the "Rule"), which was adopted in November 2010, requires broker-dealers with or providing market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. Market access is defined in the Rule as access to trading in securities on a national securities exchange or alternative trading system (ATS) as a result of being a member of the exchange or a subscriber to the ATS.²

While much of the guidance offered in the FAQs originates in the text of Rule 15c3-5 or the Adopting Release, the FAQs are an important first step in clarifying the applicability of the Rule to certain order types and entities, and providing insight into the requirement that broker-dealers maintain direct and exclusive control over their risk management controls. The primary topics addressed in the FAQs include (1) applicability of the Rule to certain entities and types of orders; (2) establishment of pre-trade capital and credit thresholds; (3) the requirement that controls be under the "direct and exclusive control" of the broker-dealer providing market access; and (4) the permissibility of certain types of controls under the Rule. Below is a summary of the most notable guidance provided in the FAQs.

Applicability of the Rule

- The FAQs clarify that the definition of "order," as used in Rule 15c3-5, is the same as in Regulation ATS, *i.e.*, "any firm indication of a willingness to buy or sell a security, as either principal or agent, including any bid or offer quotation, market order, limit order, or other priced order."³ Accordingly, the FAQs make clear that the Rule applies to quotes, and advise that a broker-dealer's risk management controls should be reasonably designed to prevent a market maker's electronic quoting system from inadvertently entering excessive quotes into the market. (FAQ No. 1.)
- The FAQs clarify that Rule 15c3-5 applies to security futures products traded on an

exchange or ATS, but note that it does not apply to futures contracts or options on futures contracts. Additionally, the Rule only applies to broker-dealers subject to Section 15(c)(3) of the Exchange Act, so notice-registered security futures broker-dealers that trade security futures are not subject to Rule 15c3-5, as they are exempt from Section 15(c)(3) of the Exchange Act. (FAQ No. 4.)

- The Rule does not apply to a broker-dealer that provides clearing services, but not market access, to another broker-dealer. A broker-dealer that enters orders on an exchange or ATS *solely* through another broker-dealer providing the market access also is not subject to the Rule. (FAQ Nos. 2-3.)
- The FAQs reaffirm that Rule 15c3-5 does not alter the existing responsibilities of entities that do not provide market access to an exchange or ATS, except if such entity is allocated regulatory responsibilities by a broker-dealer with market access pursuant to the Rule. (FAQ No. 13.)

Establishment of Pre-Trade Credit and Capital Thresholds

The risk management controls and supervisory procedures required by Rule 15c3-5 must be reasonably designed to systematically limit the financial exposure of the broker-dealer that could arise as a result of market access, including preventing the entry of orders that exceed appropriate pre-set credit or capital thresholds.⁴

- The FAQs do not provide additional guidance on how a broker-dealer with or providing market access should determine appropriate credit or capital thresholds, although they note that the selection of a particular threshold amount will require the “exercise of reasonable business judgment” by the broker-dealer. Accordingly, while broker-dealers will have flexibility in making this determination, a broker-dealer should be prepared to show (1) why it selected a particular threshold, (2) how that threshold meaningfully limits the financial exposure potentially generated by the customer or its own trading activity, and (3) the process by which it monitors the continued appropriateness of those thresholds on an ongoing basis. This guidance may be a helpful checklist for broker-dealers seeking to establish a reasonable methodology for determining credit or capital thresholds under the Rule. (FAQ No. 8.)
- The FAQs clarify that if a firm is providing market access to a broker-dealer client who may trade on an agency basis for its customers, for purposes of establishing pre-trade credit thresholds, the firm’s “customer” is the *firm’s broker-dealer client to whom it provides market access*, not the customer of such broker-dealer client. (FAQ No. 7.)
- The specific amount selected for a credit or capital threshold need only reflect an appropriate level of potential exposure for the customer or broker-dealer generated through market access, *i.e.*, through the submission of orders in securities to exchanges or ATSs, not to other trading centers (*e.g.*, OTC market makers) or for orders that are not securities. Similarly, the broker-dealer only needs to decrement the credit or capital threshold as orders in securities are submitted to exchanges or ATSs. (FAQ No. 15.)
- The FAQs make clear that in appropriate circumstances, credit or capital thresholds may be adjusted after they are triggered. If a threshold is reached, and as a result subsequent

orders are rejected, the broker-dealer may evaluate whether it is appropriate to increase the relevant threshold, and, if appropriate, do so in accordance with supervisory procedures. The reasons for such modifications should be documented and retained as part of the broker-dealer's books and records. (FAQ No. 18.)

“Direct and Exclusive Control” Requirement

Rule 15c3-5 requires that a broker-dealer's risk management controls and supervisory procedures be under the direct and exclusive control of the broker-dealer providing market access (subject to certain limited exceptions), and reviewed regularly for effectiveness.

- The FAQs clarify that a broker-dealer that provides market access to an affiliated broker-dealer may not permit the affiliate to have control over its risk management controls and supervisory procedures. (FAQ No. 10.)
- While a broker-dealer may use risk management tools or technology provided by third parties, including exchanges and ATSs, the FAQs note that if a broker-dealer has or provides market access to multiple exchanges and ATSs, and it uses multiple, stand-alone risk management control systems, these separate controls would have to be coordinated to comply with relevant regulatory and financial requirements. The FAQs note, for example, that a broker-dealer that imposes a credit limit by setting sub-limits at each exchange or ATS would have to ensure that, together, such individual limits do not exceed the aggregate credit limit. (FAQ No. 5.)
- The Adopting Release for the Rule provided that a broker-dealer relying on third-party technology or software should perform appropriate due diligence to assure that the developer is independent from the market access customer or its affiliates. While noting that the efforts required for appropriate due diligence will depend on the individual facts or circumstances, the FAQs provide the following specific examples of what such due diligence could include: (1) reviewing publicly available information about the ownership and material business relationships of the developer and the customer; (2) following up on information that may indicate a lack of independence; and (3) requesting that the developer and customer certify their independence from each other. (FAQ No. 14.)
- The FAQs caution against a broker-dealer maintaining risk management controls on its customer's premises. While this is not necessarily inconsistent with the Rule's “direct and exclusive control” requirement, it would require a rigorous assessment and ongoing monitoring of the integrity and security of the controls to assure that the broker-dealer retains exclusive control over them, and could complicate compliance. (FAQ No. 17.)

Permissibility of Certain Types of Controls

- The FAQs explain that if an order is handled on a *purely manual* basis and results in a manual execution, with no involvement of electronic systems prior to execution, then the requirements of Rule 15c3-5 can be satisfied by implementing manual pre-trade controls. This exception to the requirement that pre-trade controls be automated is fairly narrow,

however, as the FAQs note that if any electronic system is involved in any part of the execution of an order, then the broker-dealer must use automated controls. For example, if a trade is negotiated manually on an exchange floor, but the orders are entered into a trading system to be executed, automated pre-trade controls should be used when the orders are entered into the trading system. By contrast, manual pre-trade controls could be used for an order that a floor broker receives by telephone, writes on a paper ticket, and trades manually. (FAQ No. 6.)

- The FAQs provide that controls and procedures that permit malformed (“scrambled”) orders to be entered on an exchange or ATS, or that allow orders to be entered with an attempt to quickly cancel (“chase and cancel” functionality), would not be reasonably designed to prevent the entry of orders that exceed the relevant limits or parameters set by the broker-dealer with or providing market access, as required by the Rule. The FAQs warn that these types of controls not only could create a risk of execution but also potentially create operational difficulties for the exchange or ATS. (FAQ No. 16.)

The FAQs issued by the Staff provide useful guidance for broker-dealers tasked with complying with the Rule. As the Staff and market participants gain more experience with the Rule, it would be particularly helpful if the Staff periodically updated its FAQs, as it has done in other contexts.

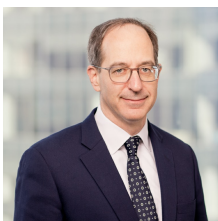
¹ Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access, SEC, Division of Trading and Markets (April 15, 2014), available at <http://www.sec.gov/divisions/marketreg/faq-15c-5-risk-management-controls-bd.htm>.

² Rule 15c3-5(a)(1), 17 C.F.R. § 240.15c3-5(a)(1).

³ See Rule 300(e) of Regulation ATS, 17 C.F.R. § 242.300(e).

⁴ Rule 15c3-5(c)(1)(i), 17 C.F.R. § 240.15c3-5(c)(1)(i).

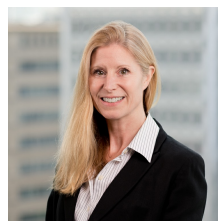
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