The Security Traders Association of New York, Inc.

Members of the Security Traders Association
39 Broadway, Suite 1840 New York, NY 10006 ● (212) 344-0410 ● Fax (212) 943-8478
e-mail - kimu@stany.org website - www.stany.org

Kimberly Unger
Executive Director

March 29, 2010

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549-1090

RE: Release No. 34-61379: File No. S7-03-10
Risk Management Controls for Brokers or Dealers with Market Access

Dear Ms. Murphy:

The Security Traders Association of New York, Inc. ("STANY")1 respectfully submits this letter in response to the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed rule 15c3-5 addressing "Risk Management Controls for Brokers or Dealers With Market Access" ("the proposed rule")Release No. 34-61379, File No S7-03-10.

STANY conducted and/or participated in numerous ad hoc meetings and discussions with its members and other market participants in an effort to identify potential common perspectives and observations concerning the proposed rule. This letter includes an overview of the most common perspectives raised by participants in these discussions and meetings as well as several alternative suggestions on how to best address the Commission's concerns about market access. This overview is not intended as a summary of all perspectives and observations raised, and no representations are made that the following perspectives and observations were uniformly shared by all participants.

In general STANY's members support the efforts of the Commission to enhance risk controls and prevent erroneous orders and orders that would violate securities laws from entering the market. We also appreciate the Commission's concerns about the potential risks to the markets that could be caused as a result of allowing sponsored access to exchanges and ATSs "where the customer order flow does not pass through the broker-dealer's systems prior to entry on an exchange or ATS."

---

[1] ***STANY*** is the voice of the trader in the New York metropolitan area and represents approximately 1,200 individuals who are engaged in the trading of equity securities. As such, we are uniquely qualified to discuss proposed rules and regulations affecting the purchase and sale of equity securities. ***STANY*** is the largest affiliate of the Security Traders Association ("STA"), a multinational professional association that is committed to being a leading advocate of policies and programs that foster investor trust, professional ethics and marketplace integrity and that support education of market participants, capital formation and marketplace innovation.

Neither ***STANY***, nor STA, represent or speak for a single business model, but rather the Associations provide forums for professionals employed by institutions, broker-dealers, ATSs and exchanges to share their prospective on issues facing the securities markets. Our members work together to promote their shared interests in efficient, liquid markets, as well as in investor protection.

The Commission seems most concerned with sponsored access wherein it believes “that, in some cases the broker-dealer providing sponsored access may not utilize any pre-trade risk management controls (i.e. ‘unfiltered ‘or ‘naked’ access), and thus could be unaware of the trading activity occurring under its market identifier and have no mechanism to control it.” Our members in general share the Commission’s concerns and support a ban on “naked” access. We are however concerned with the proposed rule because Rule 15c3-5 goes significantly beyond addressing “naked” access.

The proposed rule includes a broad definition of "market access" that encompasses sponsored access, direct market access, smart order routing, proprietary trading and agency trading. The proposed rule requires real-time risk management controls at the account level across all of these forms of market access and across all exchanges and ATSs. We believe that the proposed rule is too far reaching in its scope, addresses types of market access that do not pose significant risks, and will create duplicative, unnecessary and costly regulation in areas where additional regulation is not needed. The proposed rule will undoubtedly have unintended consequences, not the least of which is a significant increase in trading costs and a similarly significant reduction in available liquidity. Unfortunately, we do not believe that these negative consequences will be balanced by any measurable improvement in risk controls.

Although the proposed rule would apply to all forms of market access, we surmise that the Commission, legislators and public are most concerned with direct market access and sponsored access arrangements that enable clients who are not registered broker dealers or members of exchanges (or subscribers of ATSs) to self-direct the electronic routing and execution of orders to exchanges (or ATSs) with minimum or no broker dealer intervention. We believe that these arrangements should be distinguished from other uses of “sponsored” access and market access. However in its current form, proposed rule 15c3-5 would apply equally to all market access.

There are many registered broker dealers that use sponsored access of other broker dealers when they could access the markets directly without such arrangements. Such sponsored access arrangements may be used to obtain faster access to exchanges or to leverage volume benefits that sponsoring member firms enjoy. There are various reasons why an exchange member, who could access the exchange directly, would use another exchange member’s market participant identifier (“MPID”)- for example they may do so to reduce trading costs or to take advantage of tiered pricing structures offered by some exchanges and ATSs that reduce pricing for their large customers. Market participants, including members of an exchange or ATS have aggregated their order flow under the MPID of a larger exchange member to take advantage of lower costs associated with larger executions and/or larger order flow. These types of arrangements ultimately benefit customers who in turn receive lower cost executions.

Given the distinctions in the level of supervisory and regulatory controls already required and used by the majority of sponsoring firms, we seriously question whether a "one size fits all" approach to risk management is appropriate for the various types of market access encompassed in the proposed rule.

We appreciate the Commission’s interest in ensuring that there are appropriate pre and post trade controls of orders entered into the marketplace, however, current regulation and practice already provide significant controls. It is important to note that the majority of broker dealers already have in place effective controls to address pre-trade risks. Sponsoring broker dealers who have allowed others to use their MPID have been operating with the understanding that they are responsible for the activity of the clients to whom they provide access.2 As electronic trading has

---

[2] FINRA has consistently taken the view that, under FINRA rules, a firm providing market access to a third party, including another broker-dealer, or otherwise allowing a third party to

advanced member firms, have developed contractual and systemic means which not only provide protection for themselves, but which also serve to protect market integrity.

At the same time, exchanges that allow sponsored access have adopted their own rules which, among other things were designed to govern contractual relationships between sponsoring broker dealers and their sponsored clients. For example, the NYSE and BATS currently offer their members sponsored access tools aimed at protecting the integrity of their respective markets. NASDAQ OMX has recently received approval of a rule which will impose additional supervisory requirements on sponsored access arrangements for orders entered in NASDAQ's market.

The proposed rule does not appear to take into account the established concept of allocation of responsibilities provide by NYSE Rule 382 and FlNRA Rule 3230. It has long been recognized that each of the parties to a clearing and/or execution relationship is an independently registered and regulated entity with its own obligations to comply with the securities laws, rules and regulations. NYSE Rule 382, enumerates the types of functions that could be allocated between the parties by written agreement. FINRA Rule 3230 is the analog of NYSE 382 and lists the same categories of functions that may be allocated among the parties to a clearing agreement. Subsequent to their enactment these rules have been amended to enhance an introducing broker-dealer's ability to supervise its own and its customer's activities. Rules 382 and 3230 provide for an efficient mechanism to allocate responsibilities to the party in the relationship best positioned to ensure compliance.

We question whether it is beneficial to disturb the ability of parties to contractually allocate responsibilities between broker-dealers. By place the responsibility for risk control squarely and solely with the broker dealer under whose MPID an order enters an exchange or ATS, the proposed rule does not recognize that certain risk controls can be more effectively and efficiently performed at various levels along the execution chain - for example certain controls may be best implemented at the exchange level, while other controls may be most effective between the initial customer and the broker dealer with whom he placed the order. Requiring each broker dealer who enters orders directly into an exchange or ATS to develop its own software and controls will reduce certain economic efficiencies currently enjoyed by smaller broker dealers who use other broker dealers MPIDs for order entry.

Some of our members, and others with whom we spoke, believe that exchanges and ATSs are best positioned to implement certain financial risk management controls. Specifically, it is believed that exchanges and ATSs are better able to prevent the entry of erroneous orders (such as those entered or executed at prices not reasonably related to the current market), trading halts or other erroneous orders. Such risk management controls hade been in place at the exchange level in the past. The exchange's error filters would review each order submitted to the exchange prior to execution. With the implementation of Regulation NMS, latency issues inherent with pre-trade risk management filters put the exchange at a competitive disadvantage so it discontinued the use of the error filter. The Commission should consider a mandate for all exchanges, market centers and ATSs to implement appropriate and uniform financial risk management controls in connection with erroneous orders. By requiring markets to maintain uniform error filters in all exchanges, market centers and ATSs, the market will not be exposed to the risk that any individual broker's risk management system may be inadequate or fail. Market protection from erroneous orders and "fat finger" errors can be more efficiently and properly administered by the markets themselves rather than by a risk management arrangement that relies upon inconsistent

---

use the firm's market participant identifier ("MPID") is responsible for the trading conducted pursuant to that relationship.

broker dealer controls and policies that the proposed rule will require each market participant to establish.

Regulatory vs. Broker-Dealer Arbitrage

The SEC's requirement for cross-market awareness across all exchanges and ATSs appears to be an effort to prevent "regulatory arbitrage" at the exchange and ATS levels. Consistency and the avoidance of regulatory arbitrage are both valid aims, however we do not believe the proposed rule as fashioned will achieve the consistency that the Commission seeks. Without more specific details as to the types of risk controls required, the potential for "regulatory arbitrage" could be shifted from the exchanges and ATSs to broker dealers.

Since, the proposed rule contemplates that broker dealers will be required to implement systems "reasonably designed" to manage the financial, regulatory and other risks associated with market access on a pre-trade basis, there is a very real possibility that the rule will result in broker dealers competing by offering the least intrusive risk analysis. Given that risk analysis and regulatory hurdles decrease speed, firms seeking access will gravitate to those broker dealers that implement the minimum risk analysis necessary to meet the standard. We do not think it wise, nor do we believe it is the intention of the Commission, to encourage minimum risk standards or imbed incentives for firms to implement the lowest pre-trade controls permissible.

We also are concerned that without prescribing specific risk controls, audits will be difficult if not impossible to conduct fairly. For these reasons, to the extent that the Commission implements the proposed rule, we suggest that the SEC specifically proscribe required risk checks to ensure that all firms are held to the same regulatory standards.

Requirements imposed upon broker dealers by the proposed rule will be extremely costly, and difficult, if not impossible to fulfill.

The proposed rule requires that a member of an exchange or ATS, that owns an MPID that is used to trade on such exchange or ATS, provide pre-trade risk management controls for all transactions using that MPID.

The proposed rule requires that the owner of the MPID:

(i) Prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds;
(ii) Prevent the entry of erroneous orders;
(iii) Prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis; and
(iv) Prevent the entry of orders for securities for a broker or dealer, customer, or other person if such person is restricted from trading those securities.

Our members have expressed concerns about how a broker dealer who does not have a direct relationship with the "customer" entering an order can comply with all aspects of the proposed rule. Certain requirements of the proposed rule seem almost impossible to adequately monitor other than at the point of order entry. We question how a broker dealer accepting an order from another broker dealer can be expected on an order by order, pre-trade basis to know whether at the point of order origination requirements of Reg. SHO such as locate requirements, marking requirements, or applicable margin requirements were met. The requirements to maintain risk management controls reasonably designed to prevent any person from trading a stock that they are restricted from trading or to prevent the entry of an erroneous order, or to ensure that persons using the system are adequately trained, raise similar concerns. The broker dealer at the point of order origination, as opposed to the broker dealer whose MPID is being used, is in a far better position to maintain and enforce risk management controls. Moreover, as a registered broker dealer it also required to do so by existing SEC and SRO rules.

Our members have also questioned whether the owner of a MPID would continually have access to the information necessary to perform the risk checks required under the proposed rule. For example in situations where there is both an introducing broker and an executing broker; or where a large scale retail broker (e.g., E*Trade) sends consolidated trades to an aggregator the introducing broker will undoubtedly have greater access to information upon which to monitor and enforce risk management.

Many trading entities today interact with the markets through simultaneous and diverse means - separated both physically (on different exchanges or ATSs) as well as via different trading mechanisms (block orders, smart order routing, sponsored access, direct market access, etc.) trading different asset classes - they do not trade on a single system or at a single venue and do not trade a single asset class. Particularly with regard to high velocity trading, while a real-time distributed approach to risk management is necessary a more representative view of a trading firm's overall position and risk profile is possible at the "execution" versus the "order" level.

In situations involving "locked-in trades" (trades submitted by a broker dealer member of an exchange or ATS using their own market identifier but cleared through a clearing firm) the clearing firm acts essentially as the guarantor of the trades in question. A number of clearing firms shared that this was why they decided to offer sponsored access in the first place - since they were already "guarantors" of the subject trades regardless of the MPID used, they decided that it was in the best interest of their clients and their firm to allow sponsored access using the clearing firm's market identifier. Use of common market identifiers can reduce exchange and ATS fees by achieving tiered discounts submitted under common market identifiers - savings which can be shared with market participants who would never qualify for such discounts on their own.

While we support the need for pre and post trade controls, we do not believe that the proposal will provide systemic risk protection. For example, the proposed rule does not protect clearing firms from liability associated with non-sponsored access activity in situations (i.e., "locked-in trades") where the broker dealer member firm's risk management controls are ineffective. The fact that the broker dealer member firm is a registered broker dealer and a member of the exchange or ATS would subject such firm to SRO and SEC regulation and liability for noncompliance, but would not provide systemic risk protection for clearing firms if an "algo" goes awry and the broker dealer member firm is unable to stand behind the erroneous trades and goes bankrupt, thus leaving the clearing firm responsible for the trades.

<u>Counting all orders as opposed to executions for purposes of margin and credit requirements will have unintended consequences on liquidity and will not provide measurable systemic risk protection.</u>

The proposed rule appears to require broker dealers to count all orders as if they were executed without giving any accommodation to actual executions and cancellation rates. With today's high speed, computer driven and non-exchange centric market conditions, this requirement is seen by many as being unduly restrictive and likely to have a negative impact on liquidity in the market with minimal increased systemic protection over alternative approaches. Given the low level of executions as compared to orders entered on exchanges and ATSs, market risk is more realistically correlated to executions as opposed to orders. Given the percentage of orders that are actually executed, pre-order assessment does not provide a realistic assessment of risk.

Firms and individuals with whom STANY spoke offered several suggested alternative approaches to the proposed rule's mandate for measuring margin and credit requirements for each order. One such approach would include an analysis of the likelihood of an infraction occurring within the overall setting of the orders, executions and cancellation rates. This approach would result in desired improvements in systemic risk controls without adversely impacting liquidity in

the marketplace. For example, orders which have a 100% chance of violating regulations (e.g., single order quantity, single order value, restricted stock, etc) should be prevented from entering the marketplace. On the other hand, orders that would involve a regulatory infraction only if changes to account positions and / or market conditions occur should be addressed with a more algorithmic approach to risk management.

Others suggested that if a committed capital risk control is desired then, rather than counting all resting orders as executions (which could significantly curtail liquidity), orders and executions could be tracked. When executed orders reach a pre-defined percentage of the desired committed capital allocation, all open orders could be cancelled and additional orders prevented from entering the market (other than perhaps orders that would help to improve the situation).

Yet another approach proposed taking into account the liquidity and volatility of the security in question together with the relative position of any resting orders within the active "book" for that security to determine when to cancel open orders, etc.

In general, our members believe that algorithmic approaches, such as those described above, would accomplish desired improvements in systemic risk protection while acknowledging that checking in-bound orders alone without taking into account the effect of executions and cancellation rates could adversely impact market liquidity, transparency and price discovery.

The scope of the proposed rule extends beyond equities to include other asset classes under the jurisdiction of the SEC - it covers options, exchange-traded funds and debt securities as well.

STANY appreciates the Commission’s concerns with protecting the integrity of the US markets. We too want to see robust markets, with abundant liquidity, low transaction costs and integrity for all those seeking to buy and sell securities. However, in order to provide additional protection for the US economy, we believe that the Commission and other regulatory and legislative bodies should focus their concerns on areas where systemic risk posses serious potential threat. Although the proposed rule covers all forms of securities including debt, the reality is that debt does not trade on exchanges or ATSs at present so the proposed rule will do nothing meaningful in the way of addressing systemic risk in the debt market.

Bond markets, unlike stock markets, often do not have centralized exchange or trading systems. Rather, bonds trade in decentralized dealer based over-the-counter markets. Market liquidity is provided by dealers and other market participants committing risk capital. In the bond market, when a bond is bought or sold, the counterparty to the trade is almost always a bank or securities firm acting as a dealer.

As was evident during the summer of 2008 and well into 2009, the US debt markets and the role that debt based derivatives played in those markets, was at the heart of the US concern about systemic risk. The Commission is aware that the equity markets functioned extremely well during those turbulent times while the same cannot be said of the market for debt instruments. If the US and its regulators and legislators are truly concerned with systemic risk, then real reform needs to be focused on debt as opposed to equities.

Given that the proposed rule is applicable to all securities, clarity is needed as to whether risk management controls are required, or permitted, to take into account cross asset class risk implications (e.g., risk mitigation implications of underlying equity positions and related options positions).

Similarly, questions have been raised as to whether endeavors would be made to harmonize similar efforts by the CFTC with regard to futures to provide market participants with the benefit of a common approach to systemic risk management.

We have heard from our members who service institutional clients that the proposed rule is likely to act as a disincentive to institutional traders from submitting orders to exchanges and ATSs.

As the Commission has acknowledged, institutional traders and fund managers who trade block orders have legitimate concerns about information leakage that could negatively impact their executions and result in poorer prices for their clients. Institutional traders and fund mangers avail themselves of market access arrangements as a tool in their arsenal to protect anonymity of their trading interests and to limit information leakage. They have expressed concern that various mandates in the proposed rule could impair anonymity.

Some of these concerns could possibly be alleviated by the inclusion of language in the rule that would ensure that the information passed between sponsored firms and broker dealers is protected and used only for purposes necessary for risk management. The risk of information leakage could be mitigated by limiting the required pre and post trade information to that which is directly relevant to the risks associated with market access and ensuring that access to this information is limited to broker dealer compliance personnel directly associated with overseeing market access controls. The Commission could also require sponsoring firms to have specific written procedures in place to safeguard the confidentiality of pre and post trade information and limit its use to regulatory purposes.

It is our hope that the Commission will find these observations and perspectives of value in connection with the evaluation and analysis of potential changes to the proposed rule prior to adoption.

Respectfully submitted,

Kimberly Unger