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U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Attention: Ms. Elizabeth M. Murphy, Secretary

Re: Risk Management Controls for Brokers or Dealers with Market Access, **Release No. 34-61379; File No. S7-03-10 (January 19, 2010)**

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities (the "Committee") of the Section of Business Law of the American Bar Association (the "ABA") in response to the request for comments by the Securities and Exchange Commission (the "Commission") on the Commission's proposed Rule 15c3-5 (the "Proposed Rule") under the Securities Exchange Act of 1934 (the "Exchange Act"). This letter was prepared by members of the Committee's Subcommittee on Trading and Markets, with input from other members of the Committee.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, these comments do not represent the official position of the ABA Section of the Business Law.

The Committee would like to thank the Commission for this opportunity to comment on the Proposed Rule. We share the Commission's interest in reducing unnecessary systemic risk in the U.S. securities markets, and appreciate the Commission's interest in examining broader market structure issues as expressed in its Market Structure Concept Release (Exchange Act Rel. No. 61358 (Jan. 14, 2010)). We write to provide several comments. First, although the risks and concerns discussed by the Commission as the justification for the Proposed Rule are largely focused on trading risks posed by what the Commission terms "direct market access" and particularly "sponsored access," the reach of Proposed Rule 15c3-5 is much broader. Specifically, the Commission's discussion of the need for the Proposed Rule is based on the perceived risks to the equities markets posed by direct market access — when a broker-dealer allows a customer (sometimes but not always a customer with a high-frequency trading strategy) to send trade orders electronically through the broker-dealer's trading systems. The Commission's concerns are even greater with respect to sponsored access — when a broker-dealer allows a customer to place trade orders directly with markets (either with exchanges or with alternative trading systems ("ATSs")) without the orders first passing through the broker-dealer's trading systems.[1] The Commission's concerns, as explained in the Proposing Release, are at their highest with respect to "unfiltered access" or "naked access," which the Commission defines as sponsored access without the imposition of any pre-trade risk management controls.[2]

Although we understand the Commission's concerns, the text of Proposed Rule 15c3-5 sweeps much more broadly than necessary to address those concerns. The Proposed Rule applies to any broker-dealer with "market access," defined as any "access to trading in securities on an exchange or alternative trading system as a result of being a member or subscriber of the exchange or alternative trading system."[3] The Proposed Rule also applies to any broker or dealer that "provides a customer or any other person with access to an exchange or alternative trading system through use of its market participant identifier *or otherwise*" (emphasis added).[4] Defined in this way, the Proposed Rule appears to apply to all broker-dealers who execute orders for customers, other broker-dealers or for themselves on an exchange or through an ATS. The Proposed Rule does not distinguish between orders from a high-frequency trader, an institutional trader, a retail investor, or even telephonic orders that are routed to an exchange or ATS.[5] Our understanding about the extensive coverage of the Proposed Rule seems confirmed by Section III.C of the Proposing Release, which states that the definition in the Proposed Rule is "intentionally broad, so as to include not only direct market access or sponsored access services offered to customers of broker-dealers, but also access to trading for the proprietary account of the broker-dealer and *for more traditional agency activities*"(emphasis added).[6] Indeed, the Proposed Rule appears to apply to all orders handled by any firm that is an exchange member or ATS subscriber, whether or not that order constitutes "sponsored access" or even "direct market access" as those terms are ordinarily understood.[7] We request that the Commission clarify whether it intends the scope and effect of the Proposed Rule to be as broad as we

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[1] See Proposing Release at text accompanying nn. 3-4 (defining "direct market access" and "sponsored access"); id. at text accompanying nn.11-20 (explaining concerns causing the Commission to issue the proposal).

[2] Id. at text accompanying n.10.

[3] Proposed Rule 15c3-5(b).

[4] Id.

[5] By contrast, Nasdaq Rule 4611, which is discussed extensively in the Proposing Release, carefully defines "Sponsored Access," "Direct Market Access," "Member System" and "Sponsored Access System," and carefully limits the coverage of the rule to those concepts.

[6] Proposing Release at text accompanying n.33.

[7] We also request clarification whether the Proposed Rule is intended to apply to debt securities or other securities typically executed in the over-the-counter (OTC) markets, if executed by a broker-dealer that has exchange access or ATS access for exchange-listed equity securities. We note that many such OTC securities are traded in some ATSs. It is possible to read the Proposed Rule to apply to OTC orders if the broker-dealer provides market access (broadly defined) to any order in any security. We urge the Commission to clarify the intended application of the Proposed Rule as to these securities. We also request that the Commission clarify the application of the Proposed Rule to broker-dealers that provide access to foreign exchanges and ATSs.

read it to be, and if so, that the Commission explain the larger set of concerns beyond those expressed in the Proposing Release that the Commission believes need to be addressed.

The substantive requirements of the Proposed Rule — that affected broker-dealers maintain reasonably designed risk management controls and supervisory procedures, including with respect to the activities of those who trade through them — have obvious potential benefits. However, these requirements would also create substantial costs, including systems costs, delays in access, and risks of information leakage concerning customers' proprietary trading strategies. The justification for the Proposed Rule presented in the Proposing Release is phrased entirely in terms of the mitigating risks presented by sponsored access (and to a lesser extent by direct market access) in the equities markets. Extending the coverage of the Proposed Rule beyond sponsored access and direct market access to "ordinary agency activities" such as retail brokerage, and indeed retail orders accepted not only electronically but also in person and by telephone, involves substantial additional costs, and the Proposing Release does not provide an adequate justification for those costs. It is possible that the Commission could adequately justify a rule that requires all orders for all securities to be run through reasonably designed risk management systems — but in our view the Commission has not yet presented that justification.[8] If, as the Proposing Release appears to require, the Proposed Rule is not limited to sponsored access and direct market access, then we suggest that the Commission explain its rationale for such a sweeping approach, and allow the public reasonable notice of and an opportunity to comment on that justification.[9]

The Proposed Rule requires that risk management systems be under the "direct and exclusive control" of the broker-dealer.[10] For broker-dealers that are subsidiaries of multi-line financial services holding companies or that are part of other complex organizations, we believe this proposed requirement is inconsistent with current risk management best practices and would undercut the ability of those holding companies to analyze and control their systemic risks. In our experience with financial services holding companies, risk management is often a centralized function best performed at the holding company level. Holding company risk management has been encouraged by the Federal Reserve Bank as a best practice, because it enables firms to assess most efficiently and effectively the systemic risks presented across the organization.[11] Indeed, during the Commission's

8 Indeed, if the Commission's intent is to promote universal use of reasonably designed risk management systems, we do not understand why the rule should be limited to broker-dealers that provide access to exchanges and ATSs. Surely a broker-dealer active in OTC markets for government, agency, municipal and other fixed income securities could present as significant a systemic risk to the U.S. financial markets as many broker-dealers active in the exchange and ATS markets.

9 We request that the Commission confirm our assumption that the requirement in Proposed Rule 15c3-5(c)(2)(iii) that a broker-dealer permit only approved persons to have market access allows the broker-dealer to rely on a client's designation of which persons are authorized to trade on its behalf, and does not impose any additional training or other requirements on the client's choices concerning trading authority. A contrary position would improperly entangle the broker-dealer in its clients' organizational decisions.

10 Proposing Release at Section III.G.

11 In its discussion of risk management best practices, the Federal Reserve Board recommended a model that "link[s] capital to risk-taking and help[s] banking organizations compare risks and returns across diverse business lines and locations." Ben S. Bernanke, Chairman, United States Fed. Reserve, Lecture at the Stonier Graduate School of Banking: Modern Risk Management and Banking Supervision (June 12, 2006), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20060612a.htm. *Cf.* Interagency Statement on Sound

brief experience with the oversight of consolidated supervised entities, its own Rule 17i-4 mandated that risk management systems operate and report at the holding company level.[12] The language in the Proposed Rule requiring that risk management systems be under the "exclusive control" of the broker-dealer would provide complex organizations, including systemically significant financial services holding companies, with less information, rather than more, regarding potential risks and vulnerabilities. We recommend that the language of the Proposed Rule permit (indeed encourage) the current practice of consolidated holding company-level risk management. In the alternative, we urge the Commission to clarify in any adopting release that holding company-level risk management would satisfy the "exclusive control" requirement, and that such holding companies will not be required to overhaul their current risk management practices and instead perform this function at a broker-dealer level.

On a related issue, we request the Commission to explain how it intends the "direct and exclusive control" test to operate in the context of an introducing broker-clearing broker relationship. We see no obvious benefit to having duplicative risk management control requirements at both the introducing and clearing broker levels.[13] We request that the Commission clarify whether the risk management control requirement is subject to allocation between introducing and clearing brokers under NYSE Rule 382 and NASD Rule 3230, without violating the "exclusive control" requirement.

We support the standard articulated in the Proposed Rule that risk management controls be subject to a "reasonably designed" test. No risk management control system can or should be expected to eliminate trade errors completely. In some analogous situations (for example, under NASD Rule 3010 and Regulation S-P), regulators have tended to view the occurrence of a problem as conclusive evidence that the firm's controls must not have been reasonably designed to prevent that problem, as opposed to making an independent finding, supported by substantial evidence,[14] whether the firm in fact had unreasonable and inadequate controls. We urge the Commission to make it clear that this type of 20-20 hindsight (known in logic as the *post hoc ergo propter hoc*

Practices Concerning Elevated Risk Complex Structured Finance Activities, Exchange Act Rel. No. 53773 (May 9, 2006) ("Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives *from all of the relevant control functions within the financial institution*, including such groups as independent risk management, accounting, policy, legal, compliance, and financial control, in the oversight and approval of CSFTs [complex structured finance transactions] identified as having elevated risks. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in consistently managing its elevated risk CSFTs *on a firm-wide basis*.") (emphasis added).

12 As the Commission stated in Exchange Act Rel. No. 49831 (June 8, 2004): "Rules 17i-1 through 17i-8 not only create a regulatory framework for the Commission to supervise SIBHCs, but they improve the Commission's ability to supervise the financial condition and securities activities of SIBHCs' affiliated broker-dealers. The requirement that an SIBHC establish, document and maintain an internal risk management control system reduces the risk of significant losses by the SIBHC's affiliated broker-dealers. The internal risk management control system requirement also will reduce systemic risk."

13 We note that the Proposed Rule apparently would apply to orders received by one broker-dealer from another broker-dealer, which also appears somewhat duplicative and is inconsistent with the Commission's approach to order routing requirements set forth in Rule 606 of Regulation NMS.

14 See Exchange Act Section 25(a)(4).

fallacy) is not the standard by which violations of the Proposed Rule should be judged. Some of the examples cited in the Proposing Release, such as an order priced at one yen for a security the market price of which was 610,000 yen, are reasonably susceptible to being detected and prevented by risk management systems.[15] Others, such as repeated erroneous entry of a small size order,[16] may be much more difficult to distinguish from legitimate order execution strategies. Similarly, it is common for firms to execute equity orders (often very large orders) at prices outside the national best bid or offer ("NBBO") based on a reference price such as a volume weighted average price (VWAP) — the fact that an order is outside the NBBO does not mean that it should have been prevented as a likely trade error. Moreover, "fat finger" trade entry errors have occurred in the securities markets since the invention of the teletype. The Commission should make it clear that the mere existence of trade errors is not evidence that a firm's risk management control system was unreasonably designed.

Also, we suggest that the Commission recognize that what constitutes a reasonable set of controls depends in part on the resources and business model of the broker-dealer. A retail broker-dealer that primarily takes small customer orders by telephone should not be held to the same risk management control standard as a large self-clearing broker that provides electronic order-routing services to sophisticated customers. We urge the Commission to state clearly that its proposed "reasonably designed" standard is not meant to be a one-size-fits-all test that would unreasonably burden smaller broker-dealers.[17]

The Proposed Rule would require a certification by the broker-dealer's Chief Executive Officer. We question whether there is a need for this certification given the scope of existing SRO supervisory control certification rules. The Proposed Rule would require that:

> "[t]he Chief Executive Officer (or equivalent officer) of the broker or dealer shall, on an annual basis, certify that such risk management controls and supervisory procedures comply with paragraphs (b) and (c) of this section, and that the broker or dealer conducted such review, and such certifications shall be preserved by the broker or dealer as part of its books and records . . . ."[18]

FINRA Rule 3130 (which recently replaced the former NASD Rule 3013 and NYSE Rule 342.30) already requires a member firm's Chief Executive Officer to annually certify that the member has "in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance" with all applicable

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15 Proposing Release at n.16 and accompanying text.

16 Id. at n.12 and accompanying text.

17 We suggest that the Commission clarify that the requirement that broker-dealers establish and maintain risk management systems is intended for the benefit of those broker-dealers, and is not intended to create private damages liability to customers who submit erroneous orders. In a similar situation, courts have uniformly held that the margin rules are not intended to create private damages liability. *See, e.g., Bennett v. United States Trust Co.*, 770 F.2d 308, 311-13 (2d Cir. 1985), *cert. denied*, 474 U.S. 1058 (1986). Conversely, the Commission should clarify that broker-dealers do not face liability to customers for orders stopped or slowed by the broker-dealers' risk management systems as potentially erroneous, even if the customer did in fact intend to submit those orders.

18 Proposed Rule 240.15c3-5(e)(2); *see* Proposing Release at Section III.H.

federal securities laws and regulations and FINRA rules, after having received a report from and consulting with the member firm's Chief Compliance Officer.[19] NASD Rules 3010 and 3012, which were designed to complement FINRA Rule 3130, similarly require that member firms maintain supervisory control systems and written policies and procedures reasonably designed to achieve compliance with all "applicable securities laws and regulations" and to conduct annual internal inspections and testing of the adequacy of those written supervisory procedures.[20] We believe that a proliferation of separate, rule-specific CEO certification requirements would impose further burdens without providing any meaningful additional protections.[21] Indeed, we believe it is affirmatively beneficial for a CEO to consider the effectiveness of the firm's supervisory control structure as a whole, rather than on a piecemeal, rule-by-rule basis. We urge the Commission either to clarify why it considers a rule-specific CEO certification necessary in light of the already existing CEO certification rules, or to eliminate this portion of the Proposed Rule.

Finally, we suggest that the Commission take a broader view of cost-benefit analysis than that set forth in the Proposing Release. The Proposing Release examines the benefits of the Proposed Rule on a market-wide basis. However, the Proposing Release analyzes costs solely in terms of costs imposed on existing broker-dealers.[22] We believe the Proposed Rule will impose significant costs on some entities that are not currently registered as broker-dealers. For example, some algorithmic trading firms, in order to maintain their current level of access to exchanges and ATSs without the delays or risk of information leakage imposed by having their trades analyzed by another entity's risk management systems, will themselves be required to register as broker-dealers if they are to continue their current trading strategies. The process of broker-dealer registration (with the Commission, a designated examining authority ("DEA"), all relevant states and any additional SROs) is both time-consuming and expensive.[23] The Commission should estimate the number of such firms that would be required to register as broker-dealers in order to continue to implement their current trading

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19 FINRA Rule 3130.

20 Under NASD Rule 3010(c)(1) governing supervision of sales activities, members must "conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations." In FINRA Notice 08-24 (May 2008), FINRA proposed Rules 3110 and 3120 to replace NASD Rules 3010 and 3012 as part of its rulebook consolidation project, but it has not yet submitted those proposals to the Commission for approval.

21 Although we have not exhaustively surveyed all other SRO rulebooks, we believe most if not all SROs that serve as designated examining authorities adopted rules similar to FINRA Rule 3130 in the wake of the *Frank D. Gruttadauria* case, Exchange Act Rel. No. 49,589 (Apr. 21, 2004); *see also* NASD Notice to Members 04-71 (Oct. 2004) (explaining post-Gruttadauria supervisory control rules). In any event, any broker-dealer that does business with the public is required by Exchange Act Section 15(b)(8) to be a member of FINRA, and therefore is subject to FINRA Rule 3130.

22 While the Proposing Release analyzes the Proposed Rule's benefits to "investors, brokers-dealers, their counterparties, and the national market system as a whole," its exploration of costs is limited to the increased technological and legal costs faced by firms currently registered as broker-dealers.

23 Because we understand that, for example, the current FINRA registration process for a new broker-dealer takes at least six months to complete, we suggest that the Proposed Rule should not become effective for at least six months after its adoption, in order to give currently unregistered algorithmic trading firms an opportunity to complete the broker-dealer registration process in time for the effective date.

strategies, and the cost of that registration process and ongoing SRO membership for those firms, as part of its analysis of the cost of the Proposed Rule.[24]

Further, we anticipate that for at least some smaller proprietary trading firms, the expanded risk management requirements in the Proposed Rule would make it impossible for their current business models to be successful. The increased latency times required to send their orders through a broker-dealer's risk management systems would render their trading algorithms ineffective, and the initial and ongoing costs of registering as broker-dealers themselves would be greater than the profits generated by their trading algorithms can support. As a result, we expect this class of firms will go out of business entirely. We believe that the Commission should estimate the number of firms that will cease their algorithmic trading activity were the provisions of the Proposed Rule to be adopted (or will be likely to move that activity offshore), as well as the cost of the failure (or withdrawal from the market) of those firms. Finally, the Commission should estimate the costs in terms of decreased liquidity and reduced competition to the markets as a whole by forcing this group of proprietary trading firms out of the markets. The Commission might still conclude, after assessing these additional sets of costs, that the predicted benefits of the Proposed Rule continue to outweigh its costs.[25] However, the Proposed Rule clearly imposes costs on entities beyond those imposed on currently registered broker-dealers, and the Commission should evaluate all of these costs in its consideration of the Proposed Rule.[26]

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24 To the extent that algorithmic trading firms are required to register as broker-dealers so as to maintain their current level of market access, we suggest it may weaken the effectiveness of the Proposed Rule, because those new broker-dealers are unlikely to be able to establish risk management controls as sophisticated as those in place at existing large broker-dealers.

25 The Proposing Release, in Section VIII, requests comment whether the Proposed Rule would constitute a "major rule" under the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA). We respectfully suggest that when the Commission combines the costs already discussed in the Proposing Release, and the additional costs discussed in this letter, it would be difficult for the Commission to conclude that the Proposed Rule was not "major."

26 We note that in *American Equity Inv. Life Ins. Co. v. SEC*, 572 F.3d 934 (D.C. Cir. 2009), the court found that the Commission had the authority to adopt the rule at issue in that case, but its failure to consider adequately the effect of the rule on competition, efficiency and capital formation required that the rule be remanded to the Commission for reconsideration. The Commission should not make a similar error with respect to the Proposed Rule.

Once again, the Committee appreciates the opportunity to submit these comments. Members of the Committee are available to meet and discuss these matters with the Commission and its staff and to respond to any questions.

Very truly yours,

/s/ Jeffrey W. Rubin

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