Securities and Exchange Commission

Proposed Rule:

Risk Management Controls for Brokers or Dealers with Market Access
File No. S7-03-10, RIN 3235-AK53

Comments Submitted By: Mr. Christopher Carter
[redacted]

Comments Submitted Electronically on April 19, 2010

Comments Submitted To: Ms. Elizabeth M. Murphy, Secretary,
Securities and Exchange Commission
100 F Street, N.E.
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Date: April 19, 2010

I. Introduction

I am commenting on the Securities and Exchange Commission's (the "SEC" or the "Commission") proposed rule on risk management controls for brokers or dealers with market access. I thank the SEC for allowing me the opportunity to comment on the proposed rule.

I am currently a third year law student at Villanova University School of Law. Prior to Villanova, I received my BA from Boston College with a major in History and a minor in Economics. I have accepted an associate position with Bingham McCutchen, LLP, in Boston, MA, where I will have clients that have a direct interest in this rule and future rules proposed by the SEC.

While I am not submitting these comments on behalf of any other party, I do submit them as an individual investor with a great interest in the market as a whole and as a soon-to-be professional in the securities field.

The Commission, as noted in the Federal Register, has had a long history of evolving with new technologies and reacting fairly quickly to maintain efficiency in the markets while at the same time regulating the markets to address any emerging risks. With this rule, the SEC continues this trend in order to regulate the growth of automated electronic trading. Automated electronic trading has not only allowed for direct access to the markets that had never been there before, but it also brings to light the extreme risks presented by unfiltered, or "naked," access.

The enormous volume of transactions through automated electronic trading, and the lack of checks on these direct access accounts, provides a large concern for market participants. Due to the large volume of trades, even the most minor mistake can have a large impact on the market and economy as a whole. I welcome the proposed rule and suggest, as the SEC implies, that the benefits of the proposed rule far outweigh the risks.

Please note that this comment represents my view only and does not represent the views or positions of Villanova University School of Law nor does it represent the views or positions of Bingham McCutchen, LLP.

II. Summary of Comment

I am in favor of the rule as proposed, with a few minor suggestions. The rule as a whole keeps in line with the purpose of the SEC, and as such promotes a more stable market for investors to partake in.

In this comment, I address:

- A cost-benefit analysis of the proposed rule
    - The cost to Brokers and Dealers
    - The cost to Consumers
- The duty that Brokers and Dealers *should* have to the market and investors
- The market risks versus the transaction risks
- CEO certification implications
- Comparisons to the Nasdaq rule
- Specific responses to questions posed in the proposed rule

III. Proposed Rule

The proposed rule, if enacted, requires that Broker-Dealers with market access, and Broker-Dealers that provide "sponsored access," have to establish checks on transactions. Brokers and dealers would have to maintain a system of risk management controls and procedures that are designed to manage and oversee the financial, regulatory, and legal risks related to such market access.

Specifically, the proposed rule requires that Broker-Dealers establish risk management controls and supervisory procedures that are designed for two things. First, they must design safeguards to systematically limit the financial exposure of the Broker-Dealer that could arise as a result of market access. Second, Broker-Dealers must ensure compliance with all regulatory requirements that are applicable in connection with market access. In essence, the SEC wants every transaction to pass through the Broker-Dealer before making it to the exchange. The Commission wants pre-sale checks to catch initial problems before they become actual problems.

The proposed rule, as written, would require that risk management controls and supervisory procedures be under the immediate control of the Broker-Dealer and would have to be monitored in real time. Although Broker-Dealers are allowed to rely on third party providers in reaching the requirements of the risk management controls, each Broker-Dealer would still be responsible for any transactions on its Market Participant Identifier ("MPID") and would therefore be responsible for any shortfalls of the third party software.

The proposed rule also requires that Broker-Dealers annually review the effectiveness of the risk management controls and procedures and document the findings and outcomes of each review. Following each review, the CEO of each Broker-Dealer would be required to certify that the risk management controls and supervisory procedures are not only in place, but the CEO would also have to certify that controls and procedures are complete and accurate.

In sum, the proposed rule would prevent the following:

- The entry of orders that exceed the threshold levels feasible for the Broker-Dealer listed as the owner of the MPID used in the transaction;

- The entry of erroneous orders;

- The entry of orders not in compliance with regulations that must be satisfied pre-trade; and

- The entry of orders for securities that the Broker-Dealer or the customer using the MPID is restricted from trading.

In addition, the controls and procedures necessary to comply with the rule include:

- Developing an effective process for screening and approving those who use the MPIDs;

- Maintaining the software and safekeeping of all records for the trading systems put in place; and

- Restricting access to MPIDs with appropriate safeguards to prevent unauthorized access.

IV. Detailed Comments

The proposed rule seeks to not only protect the market and its investors, but also to eliminate a clear threat to market stability. While there are costs to be borne by Broker-Dealers and individual consumers, the end result is worth it. The SEC has succeeded in proposing a rule that protects market quality and preserves market efficiency. More importantly, the Commission places the burden on those in a position to carry out the protection—the Broker-Dealers with direct market access.

A. Cost-Benefit Analysis

When any government agency or commission formulates new regulations, a primary concern for those targeted by the regulations is the cost of compliance. As such, this proposed rule would create many new costs for all of the Broker-Dealers not already in compliance. Further, in order for most Broker-Dealers to comply with the proposed rule, they will be forced to pass on the cost to consumers in the form of increased transaction costs.

While the costs of compliance have been thoroughly computed by the SEC, it is important to address whether these costs outweigh the benefits of the proposed rule. In order to analyze this question, one must look to the costs for the brokers and dealers and the cost to the consumers.

1. Cost to Brokers and Dealers

The cost of implementing the proposed rule would impact brokers and dealers and it would inevitably alter the competitive landscape in the industry, increase the barriers for current brokers and dealers, and present barriers to entry in the industry. However, the benefits of the proposed rule outweigh the burden of having these barriers created and raised.

Small Broker-Dealers offer naked access to the market in order to remain competitive with the larger Broker-Dealers. By offering unmonitored direct access, the small Broker-Dealers are able to cut transaction costs and delays for the client. By requiring risk management controls, the SEC will eliminate this competitive advantage that small Broker-Dealers have had over the larger ones.

However, this additional cost has the benefit of protecting the market as a whole, and this outweighs any concern the Commission should have over small Broker-Dealers struggling to compete in the market. There has always been, and will always be, a cost to compete. Here, the cost to compete has been slightly increased so as to ensure market safety from transaction errors.

The barriers created by the proposed rule are more than necessary. An added duty should be placed on Broker-Dealers in order to insure against market failure or inaccuracies. By forcing Broker-Dealers to add costs and take on full responsibility, investors can return to merely worrying about market trends rather than market errors.

The barriers to entry will prevent risky Broker-Dealers from entering the market by requiring all Broker-Dealers to play by the same rules.

2. <u>Cost to Consumers</u>

For brokers and dealers that do not already have risk management controls that satisfy the requirements of the proposed rule, the costs will most certainly be passed on to the consumers. However, as with the additional burden placed on smaller brokers and dealers, this burden is outweighed by the benefit of having the proposed rule in place.

The additional costs of implementation can be viewed as a type of insurance for the consumer in order to enter the market. For every dollar invested into the market, a miniscule fraction of that investment will go to fund the Broker-Dealer's risk management controls. Due to the number of investors and volume of trades, the additional cost at most Broker-Dealers will be insignificant. Additionally, the costs will be minimal compared to what the losses could be without the risk management control requirements.

While losses are an expected risk when investing, one of the SEC's primary reasons for existing is to protect individual investors from having losses created by inefficiencies or market failure. As with everything else in life, protection cannot come for free. The additional cost may trouble some, but any sophisticated and knowledgeable investor should realize that this cost would have a direct relation to preserving the sanctity and security of the market. Like a surge protector, the proposed rule will nearly guarantee that a small spike (i.e., human error) will not short out the entire system.

While it can be said that some rules merely have an indirect relation to the desired goal, this proposed rule is not one of those. The filing requirements in this rule are there to guarantee compliance, and compliance will protect the market from transaction mistakes. In sum, the additional cost to consumers is outweighed by the benefit to those very consumers.

B. <u>Duty of the Broker or Dealers with Market Access</u>

The proposed rule omits a significant clause in a particular area. For the proposed rule to go from a highly beneficial rule to a rule that will undoubtedly result with strict compliance, the SEC should consider adding a private right of action section to the rule. By adding this right, Broker-Dealers would not only fear SEC sanctions and fines for non-compliance, but they would also be liable to the investors affected by transaction errors that they do not prevent. However, if a private right of action were added, it would need to be limited to only extreme situations that include great losses and reckless management by Broker-Dealer officials in order to prevent frivolous and numerous lawsuits.

With or without a private right of action, brokers and dealers should owe a duty to market participants for all transactions issued on their MPIDs. Merely holding brokers and dealers accountable is not enough; the SEC must implement a proactive approach to preventing the mistakes from happening in the first place. This is what the proposed rule seeks to do.

Broker-Dealers should be responsible for everything traded on their MPIDs and part of their responsibility should be to ensure that all trading on their MPID is legitimate and managed. As an additional safeguard, creating a duty for the Broker-Dealers will ensure that not only are the minimum requirements imposed in the proposed rule met, but also that Broker-Dealers will go a step further in checking and safeguarding each and every transaction on its MPID.

Adding a duty for the Broker-Dealers to certify every trade will have a direct impact on the safety of the market. Again, market risks are a part of investing, but transaction risks should not be, and will not be under the proposed rule, a consideration in making investment decisions.

C. <u>Market Risks v. Transaction Risks</u>

Market risks are inherent to investing and will always be present, and therefore trying to regulate against them would be too costly and inefficient. However, transaction risks are a result of human error, rather than business decisions or economic stability, and should be eliminated. The proposed rule is directed at transaction risks. An area of concern for many people is that with too much regulation the market will not be allowed to flourish. This argument, however, is misdirected when applied to the proposed rule.

The Commission states that its interest is to protect the market and the investors. Unsaid, however, is that the proposed rule will achieve this by preventing transaction risks. Investors weigh market risks when making decisions, but these risks should not need to include possible transaction risks, especially when there is technology available to nearly eliminate transaction mistakes.

The SEC already has filing requirements and necessary disclosures in order to limit some market risks, but there are few, if any, regulations that prevent transaction risks. With the volume of trading increasing dramatically, there has never been a greater need for a rule to prevent transaction risks.

Investors should not have to consider individuals with direct market access making mistakes when making investment decisions.

An efficient market does not take into account transaction mistakes. The market is flexible enough to allow for mistaken facts and statements by companies, but errant button pushes by investors and Broker-Dealers with direct access are too quick and immediate to allow for correction. The proposed rule fixes the concern over transaction mistakes and creates a much more efficient market in which investors can focus their investment decisions on facts and reports, not unregulated market access.

D. CEO Certification

An area of the proposed rule that needs alteration is the CEO certification of the risk management controls and supervisory procedures. The CEO of the company is not always adept to such issues, and more likely than not this is going to require that the CEO hire more advisors or consultants before he or she signs off on the annual reviews and documentation of the controls.

A more efficient and realistic approach to certifying these records would be to require a "senior executive" or an outside firm (like an auditing company) to sign off on the records. This will allow for some flexibility both for the situation where the Broker-Dealer has a senior executive with knowledge of the specific risk control process or has the ability to outsource the responsibility. Either way, the annual checks will be certified, but someone with more knowledge of the situation than the CEO will certify them.

E. Nasdaq Rule

A key development that undoubtedly has helped the SEC in forming the proposed rule is the recent application of a similar rule by Nasdaq. The rule that Nasdaq applied has many of the same requirements and obligations, and so far Nasdaq participants have reacted favorably to it. This is important to the Commission because it shows that a similar rule already in the market has had success and is being followed.

On January 13, 2010, the SEC approved a proposal by Nasdaq to modify its rule governing electronic access to its order execution systems. The rule is meant to ensure that each Nasdaq member assumes full responsibility for trading activity and that it has controls and risk management procedures in place to protect other market participants.

This rule was put in place due to Nasdaq's concern that naked access to its market could dramatically harm all of the members and investors because of the serious risks involved. Like the SEC, Nasdaq was erring on the side of caution with its rule. The Nasdaq rule requires that Broker-Dealers take a new look at all of the contracts it has in place that deal with access to the market and to ensure that certain requirements and safeguards are in place.

Chief among these requirements is the requirement that the Broker-Dealer takes full responsibility of any activity that takes place on its MPID when accessing Nasdaq. The Broker-Dealers then must ensure that after taking steps to specify that they have full responsibility that they also have effective financial and regulatory controls in place to protect the market from all risks associated with their clients' and their own access to the market.

The Nasdaq rule is very similar to the SEC proposed rule. This is important because one of the main markets, Nasdaq, has essentially stated that this rule is necessary in order to keep the market stable. The SEC now seeks, as it should, to apply a similar rule to all of the markets.

By creating a uniform set of rules, the SEC is keeping all market participants on the same playing field. Moreover, it cannot be understated that the Nasdaq rule is wanted by most, if not all, of the Nasdaq members and should therefore be applied to all markets.

F. Specific Responses to Questions Posed in the Proposed Rule

Does the proposed rule serve to appropriately and adequately mitigate the financial and regulatory risks associated with market access? If not, how should the Commission change the proposed rule to address these risks? Should the Commission address other risks in its proposed rule?

- Yes. This rule appropriately and adequately mitigates the financial and regulatory risks associated with market access. The core concept of the rule is, and should remain, to rid the market of naked and unfiltered access to the markets. By adding pre-trade checks, the SEC has achieved this goal and the annual reviews and certifications by the Broker-Dealers will ensure compliance.

- The SEC was also right to limit this rule to this specific type of market access so as to be able to observe the effect it has on the market. If the rule has the desired effect, which it should, only then should the SEC move into addressing and preventing other risks, whatever they may be.

Would the proposed rule affect trading volume? If so, what impact would the proposed rule have on trading volume?

- Yes. The rule would affect trading volume, but only temporarily. As with all new technology and new rules, changes can be slow at first. As soon as all Broker-

Dealers perfect the new software needed to comply with the proposed rule, the market should return to its pre-rule activity levels.

- To further strengthen this point, many Broker-Dealers already have software in place that would comply with the proposed rule, and that has not resulted in a drop in trading volume.

Would the proposed rule affect market quality? If so, what affect would the proposed rule have on market quality?

- Yes. The rule would greatly affect market quality. However, the affect would not be felt by most because it is a preventative rule. The rule will greatly stabilize the market and ensure that some risks will be eliminated. While only some will see the costs, the protection that the rule provides will be far-reaching and positive.

- All market participants are affected by market quality, and most changes that increase market quality and efficiency should be embraced. The proposed rule is an important step in decreasing transaction risks and thus promoting market efficiency and quality. Market quality cannot be at its peak when transaction risks are present.

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

- Yes. Preventing errors from happening is much more efficient than fixing them after the fact. Not only will the immediate harm be eliminated, but also preventing market failure and mistakes in the first place will keep investors feeling positive as a whole about the market. With each error and resulting damage, investor confidence is reduced.

- Pre-trade controls will not catch everything, but they surely will do more than controls taking place after the trade has already gone through to the market. Like insurance, having everyone pay a little more on the front end for pre-trade controls will end up costing the market less on the back end.

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

- Probably. Adding the controls will add a miniscule amount of time to each trade, but they will also provide for a much more efficient market. The market does not take into account human error in transactions, and thus this rule will guarantee that the market is at the point it should be.

- If the market does include human transaction errors in the prices, then this rule will bring down prices to make the market more efficient and might even cancel out the front-end costs of adding the risk controls.

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

- No. The Broker-Dealers should establish a set of criteria for determining the appropriate credit threshold for each client, but the SEC should not set the rules for such criteria. The SEC has set up appropriate safeguards in the proposed rule, but it should leave much of the specifics up to the Broker-Dealers.

- Risk assessments for clients are too fact specific for a general set of rules to be useful. The SEC would probably do more harm than good by trying to spell out every detail.

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 behavior?

- No. However, Broker-Dealers should have something in place that resembles such an early warning alert. Broker-Dealers should be allowed to choose how they comply with the rule unless the Commission determines that they are not complying properly.

- If, after the annual reports given by the Broker-Dealers, the SEC learns that the risk management controls are not preventing abuses, then the SEC may wish to reconsider an "early warning" system. To begin with, however, the SEC should allow the Broker-Dealers to regulate themselves as much as possible while within the limits of the proposed rule.

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

- Yes. The aggregate total should not be more than what the Broker-Dealer can cover, otherwise the risk management controls will mean nothing when the Broker-Dealer takes responsibility but cannot afford to fix the situation.

- However, the Commission should not fix this aggregate total. Instead, the SEC should allow each Broker-Dealer to establish its own credit levels for its customers and it should disclose this limit to the SEC. The Commission could require the disclosure and SEC approval prior to the Broker-Dealer being allowed to let its customers use its MPID.

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

- Yes. It is worth considering the possibility of placing some of the duty to monitor the risk management software and reports on an outside firm. The set-up would perhaps be more secure if it were like the system with auditors and requiring companies to use independent auditors to check records. The same should be applied here to ensure compliance.

- CEOs will have to use consultants or auditors to keep the risk management controls and supervisory procedures in compliance. The reason for this is that CEOs will be reluctant to certify anything that is not checked thoroughly. Because many CEOs will opt to outsource much of the work, requiring independent outside companies to certify records and compliance reports may add another level of needed protection. A disadvantage with this avenue of increased layers of certification, of course, is that it will increase costs even more than the proposed rule in its present form. The added layer, though beneficial, may place the costs too high for the benefit received.

Would the Proposed Rule create vertical integration in the industry, by inducing large customers (non-members) to acquire and integrate with broker-dealers? Would this potential outcome have an impact on competition in the industry?

- Probably not. The larger customers tend to already invest with the larger member Broker-Dealers. This rule may lead some customers to acquiring small Broker-Dealers, but staying with their current Broker-Dealer would probably outweigh the cost-benefit for these customers.

- If customers do acquire the small Broker-Dealers, the effect on competition in the industry would be minimal at best because the smaller Broker-Dealers would have already been struggling to compete with the inability to allow customers to have the now non-existent naked access to the markets that the larger Broker-Dealers did not provide.

V. <u>Conclusion</u>

The SEC proposed rule is without a doubt a step in the right direction. As a true proponent of a free market system, I support the proposed rule. A free market system, and an efficient market, cannot succeed when the system is too easily broken by simple mistakes.

The examples provided by the SEC of previous transaction errors that disrupted the market may not represent a large contingent of market problems, but it does present a clear warning of what can occur in the future. Risk management controls and pre-trade checks would more than likely have caught these errors before they reached the market.

A greater concern from the examples given is that these cases involved Broker-Dealer errors, not client errors. The errors committed were by experienced professionals, which should alarm market participants about the harm that can be done with naked access by individuals who get that access based primarily on assets rather than pure experience in using such technology.

The SEC is making a solid stride in creating an efficient market. Its purpose is not to take risk out of the equation for investors, but rather to take unnecessary and inefficient risks out of the market. The SEC is preventing transaction risks with this rule so that investors can turn their full attention to the rightful market risks—business performance and investor reactions.

Again, I thank the SEC for allowing me the opportunity to submit my comments on the proposed rule. The ability to comment on proposed rules before they actually become law is one that few in this world can claim to have, and one that should not be taken for granted. Thank you for to opportunity.

Respectfully submitted,

Christopher Carter