

# Clients & Friends Memo

## **The Securities and Exchange Commission Approves Nasdaq Rule on Sponsored Access and Proposes a Rule to Prohibit Naked Sponsored Access; Issues Concept Release on Market Structure**

**February 9, 2010**

The Securities and Exchange Commission (the “SEC”) approved a new Nasdaq Stock Market LLC (“Nasdaq”) rule and proposed its own Rule 15c3-5 under the Securities Exchange Act of 1934 (the “Exchange Act”), each imposing restrictions on what are commonly called “sponsored access” or “direct market access” arrangements. The Nasdaq rule imposes regulatory requirements on Nasdaq members who allow their customers to access the Nasdaq Stock Market using the broker-dealer’s identification. The SEC proposal is in the same vein, but would impose significant additional regulatory requirements and restrictions on broker-dealers that are members of an exchange or an alternative trading system (“ATS”, and collectively with an exchange, a “market”) who allow their customers to access the market under the member’s identification.

### **I. Introduction**

On January 13, 2010, the SEC approved Nasdaq’s proposal to modify its Rule 4611<sup>1</sup> (“Amended Rule 4611”). Amended Rule 4611 conditions the ability of a Nasdaq member firm to provide a customer with either “sponsored access” or “direct market access” (as each term is defined in the rule) to the Nasdaq market on the Nasdaq member having in place pre- and post-trade financial and regulatory controls.<sup>2</sup>

At the same time, the SEC unanimously approved the issuance of a proposal (the “Proposal”) that would adopt new Rule 15c3-5 under the Exchange Act.<sup>3</sup> Proposed Rule 15c3-5, which would be applicable to all “markets” (as defined above), would effectively prohibit a broker-dealer that is a

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<sup>1</sup> SEC Release No. 34-61345, File No. SR-NASDAQ-2008-104 (Jan. 13, 2010) (“Approving Release”), 75 Fed. Reg. 3263 (Jan. 20, 2010).

<sup>2</sup> Nasdaq initially filed its proposal on December 30, 2008 and subsequently filed a first amendment approximately one month later on January 28, 2009, which is the date the SEC published the initial filing together with the first amendment. SEC Release No. 34-59275 (Jan. 22, 2009), 74 Fed. Reg. 5193 (Jan. 29, 2009).

<sup>3</sup> SEC Release No. 34-61379 (Jan. 19, 2010) at 1, 75 Fed. Reg. 4007 (Jan. 26, 2010).

member of any market from providing its customers (for this purpose, the term “customer” may include other broker-dealers) with “naked”<sup>4</sup> or “unfiltered” access to a market by requiring the institutions of pre- and post-trade financial and regulatory controls that are under the “direct and exclusive supervision” of a broker-dealer that is a member of the relevant market.

Although Amended Rule 4611 was approved on an accelerated basis, Nasdaq has given no indication of when it plans to make the Rule effective. Presumably, on a purely competitive basis, Nasdaq would prefer to wait until other markets have adopted similar rules or until SEC Rule 15c3-5 is adopted and becomes effective (in which case Amended Rule 4611 would be moot). In any event, it would seem that the mandated regulatory and financial safeguards will require some time to implement and, therefore, it might be expected that Nasdaq will provide substantial notice before it declares the rule effective.

These SEC actions come against a backdrop of other recent market structure actions by the SEC, including a ban on flash orders<sup>5</sup> and tightening the display requirements applicable to “dark pools.”<sup>6</sup> Additionally, the SEC recently issued a concept release (the “Concept Release”) seeking public comment on the structure of the equity markets, with a specific focus on high frequency trading, co-locating trading terminals, and undisplayed liquidity (“dark pools”).<sup>7</sup>

A sixty day public comment period was provided with respect to the Proposal. Accordingly, comments are due to the SEC by March 29, 2010. Comments on the Concept Release are due within ninety days and should be submitted to the SEC by April 21, 2010.

## II. Sponsored Access

The term “sponsored access” in common parlance refers to an arrangement whereby a broker-dealer allows one of its customers to use its marketplace participant identifier (“MPID”) to electronically access a market. Amended Rule 4611 calls such access “**Direct Market Access**” if the pre- and post-trade controls are administered and controlled solely by the broker-dealer whose MPID is being used. Where this is not the case, Amended Rule 4611 characterizes the access as “**Sponsored Access.**” The SEC uses the terms “naked” or “unfiltered” access to refer to access

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<sup>4</sup> “Naked” has apparently become the term of choice for a practice that the SEC wishes to discredit. See, e.g., SEC Press Release 2009-172 announcing steps to curtail abusive short sales (including naked short sales) available at <http://www.sec.gov/news/press/2009/2009-172.htm>.

<sup>5</sup> SEC Release No. 34-60684 (Sept. 18, 2009), 74 Fed. Reg. 48632 (Sept. 23, 2009).

<sup>6</sup> SEC Release No. 34-60997 (Nov. 13, 2009), 74 Fed. Reg. 61208 (Nov. 23, 2009). See also Cadwalader Clients & Friends Memo: “Securities and Exchange Commission Proposes Regulation of Indications of Interest and Dark Pools” (Nov. 23, 2009), available at [http://www.cadwalader.com/assets/client\\_friend/112309\\_SEC\\_Proposes\\_Regulation\\_of\\_IOIs.pdf](http://www.cadwalader.com/assets/client_friend/112309_SEC_Proposes_Regulation_of_IOIs.pdf).

<sup>7</sup> SEC Release No 34-61345; File No. SR-NASDAQ-2008-14.

that occurs without direct oversight from the broker-dealer—Rule 15c3-5 would prohibit this practice.

Both Amended Rule 4611 and proposed Rule 15c3-5 impose supervisory, recordkeeping and reporting requirements on access arrangements. However, there are two significant substantive differences between Amended Rule 4611 and the SEC Proposal.

First, Amended Rule 4611 allows a party other than the broker-dealer, including the customer, to control and maintain the necessary pre- and post- trade controls; by contrast, the SEC Proposal would require that such controls be under the direct and exclusive control of the broker-dealer that is a member of the relevant market.<sup>8</sup> The SEC Proposal does, however, permit the broker-dealer to use a third party to develop risk management technology, supplement monitoring and perform routine maintenance, provided the third party is “independent of customers provided with market access.”<sup>9</sup>

Second, the SEC Proposal would require that the broker-dealer’s CEO annually certify that risk management systems comply with Rule 15c3-5 and that they are regularly reviewed by the broker-dealer.<sup>10</sup>

#### **A. The Nasdaq Rule: Amended Rule 4611**

Nasdaq stated that the purpose of Amended Rule 4611 is to ensure that each member assumes “full responsibility for its customers’ trading activity and has effective financial and regulatory controls in place.”<sup>11</sup> Amended Rule 4611 is a significant change from the prior rule (which remains in effect pending the effectiveness of Amended Rule 4611).<sup>12</sup> First, it distinguishes between two types of access involving a Nasdaq member (a “Sponsoring Member”) who provides market access to another person, firm or customer (a “Sponsored Participant”). In “**Direct Market Access**,” the Sponsored Participant makes decisions about the order routing and order entry, but orders pass through a “Member System”; *i.e.*, one administered and controlled by the Sponsoring Member. In

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<sup>8</sup> Proposal at 31.

<sup>9</sup> *Id.* This requirement as drafted may be problematic where the broker-dealer is affiliated with the relevant customer, as a “third party” affiliated with the broker-dealer might not be independent of the customer.

<sup>10</sup> *Id.* at 34.

<sup>11</sup> Approving Release at 2.

<sup>12</sup> The currently effective rule primarily imposes an agreement obligation on the Nasdaq Member and sponsored access customer; *i.e.*, (i) requires that the Nasdaq member obtain an agreement from the customer using market access that the customer would comply with Nasdaq’s Rules as if it were a member, and (ii) reminds the member that it is responsible for its customers’ actions in using market access.

“**Sponsored Access,**” an order does **not** pass through a Member System but only through a Sponsored Access System; *i.e.*, one not controlled by the Sponsoring Member.

Amended Rule 4611 requires a Nasdaq Member firm providing market access to:

- maintain **pre- and post-trade financial controls** to safeguard against customers surpassing credit thresholds, trading in restricted securities, and submitting erroneous orders.
- maintain internal **pre- and post-trade regulatory controls**, including the real-time receipt and timely review of relevant trade activity.
- where a third party control system is used, impose **contractual obligations** on the customer and on the third party designed to ensure regulatory compliance.

Financial and Regulatory Controls. Amended Rule 4611 requires financial controls to prevent a Sponsored Participant from doing the following:

- Entering orders that in the aggregate exceed pre-set credit thresholds or other set thresholds.
- Trading a product the Sponsoring Member or Sponsored Participant is restricted from trading.<sup>13</sup>
- Submitting erroneous orders.

The Nasdaq Rule also mandates that the Sponsoring Member establish system controls that are reasonably designed to ensure compliance with regulatory requirements. In addition, the Sponsoring Member must ensure that appropriate supervisory personnel receive and review timely reports of all trading activity by its Sponsored Participants. Such review should be sufficient to permit the Sponsoring Member to comply with applicable regulatory requirements and to monitor for illegal activity.

Contractual Provisions. With respect to Sponsored Access (where orders are not required to pass through a Member System), Amended Rule 4611 requires that the Sponsoring Member enter into an agreement with each Sponsored Participant under which each Sponsored Participant agrees to (i) comply with all SEC and Nasdaq rules, (ii) allow the Sponsoring Member to have access to its books and records and financial information, (iii) maintain trading activity within credit, product or other financial limits specified by the Sponsoring Member, (iv) familiarize itself with Nasdaq rules

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<sup>13</sup> Amended Rule 4611 includes this provision under the heading “financial control” while the SEC Proposal has a similar provision it deems a “regulatory risk management control.”

and not allow unauthorized users to access Nasdaq, and (v) allow the Sponsoring Member or Nasdaq to terminate access if there is a risk to the integrity of the market.

If a third party is providing the risk management controls for Sponsored Access, an additional agreement is required to allow the Sponsoring Member to have access to the third party provider's system to confirm compliance with applicable laws and terminate access on account of non-compliance. In addition, the third party provider must agree to prevent unauthorized access to the system.

#### **B. SEC Proposal: Rule 15c3-5**

The SEC is requesting comments on its proposed Rule 15c3-5, which will require that all orders entered by a customer pass through a broker-dealer system that has risk management and compliance controls under the direct and exclusive supervision of the broker dealer. Unlike the Nasdaq Rule, the Proposal would not allow a third party to oversee these controls. The SEC asserts that allowing an unregulated third party to supervise market access creates too much risk to the integrity of the market.<sup>14</sup>

In issuing the Proposal, the SEC noted its concern with the possible negative systemic impact of automated, high-speed trading.<sup>15</sup> In light of the speed at which trades can be executed,<sup>16</sup> the SEC is concerned with financial exposure resulting from the breach of credit or capital limits and erroneous orders,<sup>17</sup> as well as the fear that automatic high frequency trading can cloak fraudulent trading schemes and other non-compliance with SEC or market rules.<sup>18</sup>

Under the Proposal, a broker-dealer providing market access would be required to:

- Create **pre-trade financial risk management** controls that automatically prevent entry of erroneous orders or orders that exceed pre-set credit or capital thresholds.
- Create systemic **pre-trade regulatory risk management** controls that are reasonably designed to ensure regulatory compliance.

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<sup>14</sup> Proposal at 31.

<sup>15</sup> Proposal at 9-11.

<sup>16</sup> The SEC noted that trade executions can occur in milliseconds or less. Concept Release at 15; Proposal at 9.

<sup>17</sup> In October 2009, the SEC approved a number of exchange rules for breaking "clearly erroneous" stock trades that substantially deviate from market practice, colloquially referred to as the "fat finger" rule. See "SEC Approves New Exchange Rules for Breaking Clearly Erroneous Trades" available at <http://www.sec.gov/news/press/2009/2009-215.htm>.

<sup>18</sup> See Proposal at 56-57.

- Maintain risk management controls and supervisory procedures under the **direct and exclusive control** of the broker-dealer.
- Require the **CEO to annually certify** that the broker-dealer has in place a system to regularly review the effectiveness of its risk management system and to promptly address any issues.<sup>19</sup>

Financial and Regulatory Risk Management Controls. The financial controls are similar to those in Amended Rule 4611.

With respect to regulatory controls, the Proposal would require that supervisory safeguards be in place to “prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order basis.” Similar to Amended Rule 4611, the Proposal would require risk controls in place to prevent specific restricted securities from being entered, prevent unauthorized access and allow surveillance personnel to receive post-trade execution reports.

The Proposal is principle-based (or at least it is broadly drafted) stating that pre-trade controls should exist that are reasonably designed to ensure compliance with **all** regulatory rules related to market access. For illustrative purposes, the Proposal notes that compliance should include exchange and SEC rules relating to special order types, trading halts, odd-lot orders, Regulation SHO, Regulation NMS and margin requirements and additionally restrict certain securities.<sup>20</sup>

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The Nasdaq Rule and the Proposal both reflect the SEC's concern with the possible negative systemic impact of automated, high-speed trading in general<sup>21</sup> and the fear that such trading can be used to cloak fraudulent trading schemes and otherwise evade compliance with the SEC and market rules.<sup>22</sup> Certainly, it would seem reasonable to require that electronic trading systems have automated procedures to prevent fat finger or other obviously erroneous trades. That said, whether the reasonable concerns justify the overall proposal, or they are simply a response to the politics

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<sup>19</sup> It is not clear why CEO signoff would be required for this particular rule. The CEO of a broker-dealer is already required to certify or to affirm compliance generally. See, e.g., FINRA Rule 3130 requiring annual certification of compliance and supervisory processes. The Proposal notes that CEO certificate “would help ensure that senior management review the efficacy of its controls and procedures at regular intervals and that such review is documented.” Proposal at 44. While this is undoubtedly true, it is also equally true of any other rule. Accordingly, it is not clear why this proposal merits such attention or whether this may be the beginning of a trend of heightened CEO responsibility.

<sup>20</sup> Proposal at 29.

<sup>21</sup> Proposal at 9-11.

<sup>22</sup> Proposal at 56-57.

and newspaper stories of the moment, is a difficult question to answer. Certainly, as with many of the SEC's proposals, the estimated expense seems much lower than we would have guessed and some of the burdens imposed, including CEO certification, seem excessive.<sup>23</sup>

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<sup>23</sup> The Proposal estimates that the costs per broker-dealer will be (i) for the initial burden: 150 hours (technology) and 35 hours (legal compliance), (ii) for the ongoing annual burden: 115 hours (technology) and 45 hours (legal compliance), (iii) for initial hardware and software expense: \$16,000, and (iv) for ongoing costs: \$20,500. Proposal at 52.

**Required Risk Management Controls**

Provision	Nasdaq Rule 4611	SEC Proposed Rule
<b>Allows third party service provider to establish and maintain risk controls</b>	Yes – in Sponsored Access Situations	No – must be under direct and exclusive control of broker or dealer
<b>Pre-set limits</b>	Yes – Aggregate credit limits, or other	Yes – Aggregate credit or capital limits, or other
<b>Restrictions on trading</b>	Yes – if Sponsoring Member or Sponsored Participant is restricted	Yes – if the broker-dealer is restricted
<b>Prevention of erroneous orders</b>	Yes	Yes
<b>Reasonably designed controls to ensure compliance with all regulatory requirements</b>	Yes	Yes
<b>Restrict access to authorized users; keep physically secure</b>	Yes – as part of the contractual agreement with the Sponsored Participant and third party	Yes – as overseen by the broker-dealer
<b>Immediate post-trade execution reports</b>	Yes	Yes
<b>Regular reviews of the effectiveness of the controls and supervisory procedures</b>	No	Yes
<b>Annual review; certification by broker-dealer CEO</b>	No	Yes