10 Years On, SEC's Market Access Rule Still Lacks Clarity

By **Ashley Bashur and Paul Eckert** (October 8, 2021)

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The first 10 years of the U.S. Securities and Exchange Commission's Rule 15c3-5, known as the market access rule,[1] have been a textbook example of the principle of regulation by enforcement, resulting in an informal patchwork of guidance, mostly led by decentralized self-regulatory organizations, or SROs, and the payment of approximately $80 million in fines.

While the SEC's goal of adopting a rule that was not overly prescriptive and that could be tailored to each firm's circumstances may have been well-intentioned, the lack of formal guidance following the rule's adoption led to unclear standards and moving targets for broker-dealers.

Broker-dealers subject to the rule — those that have or provide market access — would be better equipped to meet regulatory expectations if the SEC and SROs clarified those expectations through customary, broadly available interpretive pronouncements, especially since technology, trading and markets have changed significantly over the past 10 years, and conforming systems and procedures to evolving and, at times, conflicting expectations can be both inefficient and costly.

Instead, the SEC, the Financial Industry Regulatory Authority and various exchange SROs have chosen to articulate standards and expectations through a patchwork of public settlement documents with individual firms, and through informal speeches and conversations with counsel during the course of investigations.

Additionally, regulators have chosen to use the market access rule as a catchall provision, allowing them, for example, to bring actions against firms for failing to detect potentially manipulative trading activity, without requiring any proof of actual manipulation.

Because FINRA and the exchange SROs continue to enforce the rule at a level of granularity likely not intended by the SEC in 2010 when the rule was adopted, formal guidance is even more crucial at this juncture, especially as two potential areas of regulatory scrutiny — cryptocurrency and payment for order flow — could result in more broker-dealers being subject to the rule.

Background

In 2011, when Rule 15c3-5 went into effect, broker-dealers who provide market access to exchanges or alternative trading systems, or ATSs, were required to have controls and procedures designed to manage the risks inherent in providing market access.[2]

The SEC adopted Rule 15c3-5 after the May 2010 flash crash, when an order placed using an algorithm caused the Dow Jones Industrial Average to plunge about 1,000 points in a matter of minutes.[3]

The SEC wanted to address the risks associated with high-frequency and other algorithmic trading, emphasizing in its adopting release that "the potential impact of a trading error or a rapid series of errors, caused by a computer or human error, or a malicious act, has become

more severe."[4]

Rule 15c3-5 requires broker-dealers that have or provide market access to establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of this business activity.[5]

"Market access" is defined in the rule as access to trading in securities on an exchange or ATS as a result of being a member or subscriber.[6]

The SEC emphasized in its adopting release that the rule, which sets forth broad goals to be attained by broker-dealers providing market access but does not mandate specific controls and procedures, afforded broker-dealers flexibility in crafting the required controls and procedures, so long as they are "reasonably designed to achieve the stated goal."[7]

The rule has not been amended since its adoption, and the only guidance issued by the SEC not in connection with a specific matter is a set of frequently asked questions released by the SEC's Division of Trading and Markets in April 2014.[8]

Enforcement Trends

Since the rule's implementation in 2011, regulators have brought approximately 110 enforcement actions[9] against firms for violations of Rule 15c3-5, resulting in over $80 million in fines.[10]

While the SEC has been responsible for a little over half of that amount — $41 million — the SEC has initiated just eight enforcement actions for violations of the market access rule, with the most recent settlement in April 2017.[11] The remaining enforcement actions have been brought by SROs such as FINRA.[12]

For actions in which the primary violation was of the market access rule, SEC fines have ranged from $310,715 to $12.5 million, and the SROs' fines have ranged from $7,500 to $6.5 million.

Regulators have required undertakings in approximately 54% of the settlements, which typically include implementing or revising the firm's written supervisory procedures but, on occasion, have required a firm to retain an independent consultant.[13]

During the first few years of the rule's existence, the SEC brought event-driven actions where a firm's erroneous order or technology lapse caused significant market impact. These settlements included large fines, and signaled to the industry that the ramifications for not taking the rule seriously would be significant.

These and other settlements during this time frame also established minimum benchmarks for controls required by the rule, such as a security-specific control that prevents orders above a stock's average daily volume, and a control that prevents an excessive number of messages. These controls were not addressed by the SEC rule, or its proposing or adopting releases.

Finally, the challenges to the adequacy of controls in these matters suggest that the SEC and other regulators expect firms to have documented rationales for each of the parameters of their controls, and that controls set at extremely high levels, such as a notional control set at $1 billion, will not be considered reasonably designed.

The next phase of enforcement actions, brought mostly by SROs, involved highly technical and prescriptive violations covering all aspects of the rule. There have been dozens of these settlements every year, each announcing or reinforcing evolving norms that have become part of a patchwork of informal guidance to the industry.

Most of these enforcement actions were brought by FINRA or other SROs, and the fines generally were lower than the initial set of matters.

In many instances, the SROs found firms in violation of the rule for failing to have adequate written supervisory procedures or sufficient documentation of the rationale for controls, without making any finding that these failures caused or contributed to either market-impacting events or erroneous orders reaching the market.

Finally, many of the most recent settlements involve firms' failures to implement reasonably designed post-trade reviews for manipulative trading activity. In some instances, it appears that regulators have used the market access rule to fine a firm for failing to detect its customer's potentially manipulative trading, without a finding of any intent by the customer, or the firm providing market access, to manipulate the market.

Thus, the rule has been used as a proxy for the anti-fraud provisions, where a regulator need not prove the elements of the fraud.

For example, instead of charging the customer responsible for the orders with manipulating the market, the regulator charges the broker-dealer providing market access to the customer for failing to detect an alleged or potential manipulation and failure to supervise the activity more generally.

For example, in July, FINRA settled with CODA Markets Inc. on its own behalf and on behalf of other SROs for violation of the market access rule, among other rules, and required payment of an aggregate fine of $1.25 million and an undertaking.[14]

FINRA and the SROs found that CODA Markets failed to establish and maintain a supervisory system and regulatory risk management controls reasonably designed to monitor for potentially manipulative trading, such as potential layering, spoofing, wash trades, prearranged trades, marking the close and odd-lot manipulation.

According to the settlement documentation, CODA Markets generated 350,000 alerts at FINRA and the SROs during the relevant period.

Though FINRA did not determine that CODA Markets failed to detect actual instances of manipulative trading, the organization did conclude that CODA Markets' failures resulted in potentially manipulative trading occurring through its channels. Specifically, FINRA said that these deficiencies caused hundreds of millions of orders to enter the markets without being subjected to reasonably designed risk management controls or reasonably designed post-trade supervisory reviews.

The enforcement actions for violations of the rule during the past 10 years have set forth the regulators' evolving expectations for what firms must have in place to comply.

Evolving Regulatory Expectations

The market access rule was designed to allow firms to craft their own reasonably designed

controls and supervisory procedures specific to their businesses, with refinements over time to address experience as markets and technology evolve. It was a rare instance of a principles-based regulation addressing U.S. market structure.

Over time, however, regulators have become increasingly prescriptive about what will be deemed reasonable in terms of specific controls and their associated features, design, metrics and documentation.

Identifying these expectations — which have never been the subject of SEC notice-and-comment rulemaking, interpretive releases or even staff pronouncements beyond the 2014 FAQ — requires scrutinizing voluntary settlements involving firms with a variety of business models and market positions for clues as to how broadly findings may be applied to other firms.

In the absence of published, generally applicable guidance, that insight, together with firm-specific feedback from examination reviewers and enforcement inquiries, must be used by firms to conform systems to perceived staff expectations. A few examples of these expectations are provided below:

- Parameters for pre-trade controls should be narrowly tailored based on the business or client and have a documented rationale with supporting empirical data.

- Firms should have security-specific controls, including, for example, ADV controls and price controls that use security-specific tiers. These controls should be applied during all hours of trading, including before the market opens and after the market closes, and when a standard measure of market price (e.g., national best bid and offer) is not available.

- Firms should have controls designed to limit the number of messages sent to the market that are supported by empirical data. Firms should also ensure that clients do not avoid triggering these controls by using multiple instances or gateways to the market.

- Controls with an ability to prevent market impact, not just erroneous orders, are becoming increasingly important.

- Post-trade reviews designed to detect potential market manipulation should be effective, in that firms will be asked why certain activity that triggered the regulators' surveillance alerts was not also detected by a firm's surveillance reviews.

- Firms should have very clear and specific written supervisory procedures guiding its post-trade reviews. These procedures should provide adequate guidance to those performing these reviews and ensure that red flags are followed up on. Asking the client for an explanation of the activity alone may not be sufficient to justify closing the alert.

- Firms should have policies and procedures that provide how the annual review of market access controls and procedures is performed and require documentation of such reviews, which should include testing of controls.

Looking Ahead

The market access rule will continue to play a large role in the regulatory landscape for broker-dealers that are subject to the rule.

For example, some of the potential areas of interest for FINRA this year included:

- Deployment of technology, including kill switches, to prevent marketwide events;

- Credit limit adjustments, including how firms adjust them intraday and what automated controls are in place to revert ad hoc adjustments;

- Vendor due diligence, including how a firm ensures its vendors' compliance with the rule and maintains direct and exclusive control pursuant to Rule 15c3-5(d);[15] and

- Testing of controls, including how the testing is incorporated into the required CEO certification pursuant to Rule 15c3-5(e).[16]

In addition to continuing scrutiny of firms' existing market access programs, the scope of entities subject to the rule may expand based on two areas of potential regulatory development.

First, SEC Chair Gary Gensler recently said in an interview that the commission is considering banning the practice known as payment for order flow,[17] in which retail broker-dealers send marketable orders to wholesale market makers for execution in exchange for payment for the flow.[18]

Currently, firms who route orders to broker-dealers for execution, not directly to the market, are exempt from the rule's requirements.[19]

In theory, if payment for order flow is banned, this could disincentivize retail broker-dealers

that currently route customers' orders exclusively to other broker-dealers for execution from continuing this practice, thus opening the door for these broker-dealers to route directly to exchanges and ATSs. Thus, this change could result in more broker-dealers being subject to the rule.

Second, the regulatory status of cryptocurrency is not clear; however, if Congress, the SEC or a court determines that certain forms of cryptocurrency or digital assets are securities, then the market access rule, in theory, would apply to broker-dealers who route orders in those securities to an exchange or ATS.

Unless the SEC formulates an entirely separate regulatory regime governing these types of securities, or declares them exempt from Rule 15c3-5, these firms will be subject to the rule. This would likely result in a brand-new set of enforcement actions against broker-dealers — including those that exclusively route cryptocurrency or digital assets deemed to be securities — for violations of the market access rule.

Conclusion

Rather than provide detailed requirements in the rule or in formal guidance, the SEC chose to articulate standards for the market access rule through enforcement actions brought by itself and the SROs. As a result, firms were left with a patchwork of guidance for how to comply with a very costly rule, mostly in the form of settlements where the public documentation is sparse and light on factual context.

Despite the rule requiring reasonably designed controls and supervisory procedures, regulatory expectations have evolved over time to include fairly granular requirements under the rule.

We expect that regulators will continue to bring actions for violations of the market access rule that span a number of topics discussed in this article.

In light of the potential expansion of the types of broker-dealers subject to the rule, we hope that the SEC issues formal guidance to provide more clarity as to its expectations going forward.

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[1] 17 C.F.R. § 240.15c3-5 (2010).

[2] Risk Management Controls for Brokers or Dealers With Market Access, Final Rule, 75 Fed. Reg. 69792 (Nov. 15, 2010) ("Adopting Release").

[3] Findings Regarding the Market Events of May 6, 2010, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, at 1-2 (Sept. 30, 2010), available at http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

[4] Adopting Release at 69794.

[5] 17 C.F.R. § 240.15c3-5(b).

[6] Id. § 240.15c3-5(a)(1).

[7] Rule 15c3-5 Adopting Release at 69801.

[8] Responses to Frequently Asked Questions Concerning Risk Management Controls for Brokers or Dealers with Market Access, U.S. Sec. & Exch. Comm'n, Division of Trading and Markets, FAQ No. 1 (April 15, 2014) ("Rule 15c3-5 FAQs"), available at https://www.sec.gov/divisions/marketreg/faq-15c-5-risk-management-controls-bd.htm.

[9] This total counts as one related enforcement actions brought by multiple regulators for substantially the same conduct, as indicated in the settlement documents. In most circumstances, the settlement documents for related actions contain an aggregate fine, in addition to the portion of the fine payable to the particular regulator executing the settlement document.

[10] This excludes matters that include findings of violations of the market access rule, but are overwhelmingly focused on other conduct and putative violations.

[11] In re Wilson-Davis & Company, Inc. , Exchange Act Rel. No. 80533 (April 26, 2017).

[12] In addition to bringing its own enforcement actions, FINRA also brings actions on behalf of Exchange SROs, pursuant to Regulatory Service Agreements.

[13] See, e.g., In re Wedbush Securities Inc. , Jeffrey Bell, and Christina Fillhart, Exchange Act Release No. 73652, Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 and Section 203(e) of the Investment Advisors Act of 1940 as to Wedbush Securities Inc. (Nov. 20, 2014).

[14] CODA Markets, Inc., FINRA AWC No. 2015044078201 (July 28, 2021).

[15] See also FINRA Regulatory Notice 21-29, Vendor Management and Outsourcing (Aug. 13, 2021), available at https://www.finra.org/rules-guidance/notices/21-29 (reminding firms of their supervisory obligations related to outsourcing to third-party vendors).

[16] See Report on FINRA's Examination and Risk Monitoring Program at 35 (Feb. 2021), available at https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf.

[17] Avi Salzman, SEC Chairman Says Banning Payment for Order Flow Is 'On the Table', Barron's (Aug. 30, 2021).

[18] SEC Staff Report on Algorithmic Trading in U.S. Capital Markets at 31 (Aug. 5, 2020), available at https://www.sec.gov/files/Algo_Trading_Report_2020.pdf.

[19] See Rule 15c3-5 FAQs, FAQ No. 3.