



CBOE Regulatory Circular RG11-065  
C2 Regulatory Circular C2 RG11-004

To: CBOE, C2 and CBSX Trading Permit Holders  
From: Registration and Regulatory Services Division  
Date: May 26, 2011  
Re: New SEC Rule 15c3-5  
Risk Management Controls for Brokers or Dealers with Market Access

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This circular is to remind CBOE, C2 and CBSX Trading Permit Holders that the compliance date for the new market access requirements set forth in SEC Rule 15c3-5 is scheduled for July 14, 2011, and Trading Permit Holders must have the required controls and procedures in place by that time.

### **General Overview of Rule 15c3-5**

On November 3, 2010, the SEC adopted Rule 15c3-5, which requires a broker-dealer with market access to an exchange or alternative trading system, or 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, 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 its business activity.

- The term “market access” is defined in Rule 15c3-5 to mean “(i) 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, respectively; or (ii) access to trading in securities on an alternative trading system provided by a broker-dealer operator of an alternative trading system to a non-broker-dealer.”
- The Rule applies to transactions by all broker-dealers with market access, and does not distinguish between transactions for the proprietary account of the broker-dealer (including market making activities) or for more traditional agency activities.
- By virtue of its requirements, the Rule prohibits broker-dealers from providing “unfiltered” or “naked” access to an exchange or ATS.

### **Risk Management Controls and Supervisory Procedures**

As provided in Rule 15c3-5, the risk management controls and supervisory procedures must include the following elements:

#### **Financial Risk Management Controls and Supervisory Procedures**

The financial risk management controls and supervisory procedures must be reasonably designed to systematically limit the financial exposure of the broker or dealer that could arise as a result of market access, including being reasonably designed to:

- Prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker or dealer and, where appropriate, more finely-tuned by sector, security, or otherwise by rejecting orders if such orders would exceed the applicable credit or capital thresholds; and
- Prevent the entry of erroneous orders, by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time, or that indicate duplicative orders.

The financial risk management controls and supervisory procedures described above must be under the direct and exclusive control of the broker-dealer with market access.

### **Regulatory Risk Management Controls and Supervisory Procedures**

The regulatory risk management controls and supervisory procedures must be reasonably designed to ensure compliance with all regulatory requirements, including being reasonably designed to:

- Prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis;
- 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;
- Restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer; and
- Assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.

The regulatory risk management controls and supervisory procedures described above must be under the direct and exclusive control of the broker-dealer with market access. However, Rule 15c3-5 provides that a broker-dealer with market access may reasonably allocate, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures to a customer that is a registered broker-dealer, provided that such broker-dealer with market access has a reasonable basis for determining that such customer, based on its position in the transaction and relationship with an ultimate customer, has better access than the broker-dealer with market access to that ultimate customer and its trading information such that it can more effectively implement the specified controls or procedures. Rule 15c3-5 further provides that any such allocation of control shall not relieve a broker-dealer with market access from any obligation under the Rule, including the overall responsibility 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 market access.

### **Regular Review of Controls and Supervisory Procedures**

Rule 15c3-5 provides that a broker-dealer with market access must establish, document, and maintain a system for regularly reviewing the effectiveness of the risk management controls and supervisory procedures required by the Rule and for promptly addressing any issues.

- Among other things, the broker-dealer with market access must review, no less frequently than annually, the business activity of the broker-dealer in connection with market access to

assure the overall effectiveness of its risk management controls and supervisory procedures. Such review must be conducted in accordance with written procedures and must be documented. The broker-dealer must also preserve a copy of such written procedures, and documentation of each such review, as part of its books and records in a manner consistent with Rules 17a-4(e)(7) and 17a-4(b), respectively, under the Exchange Act.

- The Chief Executive Officer (or equivalent officer) of the broker-dealer with market access must, on an annual basis, certify that such risk management controls and supervisory procedures comply with the Rule, and that the broker-dealer conducted such review, and such certifications must be preserved by the broker-dealer as part of its books and records in a manner consistent with Rule 17a-4(b) under the Exchange Act.

Trading Permit Holders are reminded that these controls and procedures are subject to review during the course of a financial or regulatory examination.

### **Additional Information and Other Considerations**

Please note that the foregoing description of SEC Rule 15c3-5 is a summary and the actual rule text and SEC adopting release are controlling. Trading Permit Holders should review the adopting release on the SEC website at <http://www.sec.gov/rules/final/2010/34-63241.pdf>. The SEC has also made available a Small Entity Compliance Guide, which is located at <http://www.sec.gov/rules/final/2010/34-63241-secg.htm>.

Please also note that the Exchange is assessing whether changes to its sponsored user rules are appropriate to align the rules with Rule 15c3-5. To the extent that the rules may conflict, SEC Rule 15c3-5 is controlling. However, Trading Permit Holders should note that sponsored user access arrangements must continue to comply with all other Exchange requirements.

Finally, please note that the Exchange does not anticipate disabling any existing connectivity arrangements solely as a result of SEC Rule 15c3-5 going into effect. All Trading Permit Holders must ensure that any connectivity arrangements are in compliance with the Rule before July 14, 2011.

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If you have questions regarding SEC Rule 15c3-5, you should speak with your firm's compliance or legal department. You may also contact the SEC. To the extent you have further questions, those inquiries may also be directed to the Registration and Regulatory Services Division at (312) 786-7730 or (312) 786-8460.