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March 29, 2010

Via Electronic Mail

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

Re: **Risk Management Controls for Brokers or Dealers with Market Access; File No. S7-03-10**

Dear Ms. Murphy:

Investment Technology Group, Inc. ("ITG") appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission ("SEC" or "Commission") to adopt new Rule 15c3-5 ("Rule") under the Securities Exchange Act of 1934 ("Exchange Act").[1] The Rule would require broker-dealers with access to trading directly on an exchange or an alternative trading system ("ATS") to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. ITG is an independent agency brokerage and financial technology firm that partners with asset managers globally to improve performance throughout the investment process. ITG also operates an ATS called POSIT® that conducts matches of non-displayed, unpriced orders from institutional investors and broker-dealers. Thus, as both an agency broker and an operator of an ATS, ITG has a diverse background from which to comment on the SEC's proposal.

The Commission's proposal arises from the concern that the increased speed and automation of trading on exchanges and ATSs and the growth in direct market access and sponsored access arrangements may pose various financial and regulatory risks for broker-dealers providing such access and systemic risks to the market as a whole.[2] As a

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[1] See Securities Exchange Act Release No. 61379 (Jan. 19, 2010), 75 FR 4007 (Jan. 29, 2010) ("Proposing Release").

[2] As the Commission notes in the Proposing Release, "direct market access" arrangements (or "DMA" arrangements) are commonly understood to refer to arrangements in which a customer's orders flow through the broker-dealer's systems before passing into the markets, and "sponsored access" arrangements are commonly understood to refer to arrangements in which a customer's orders flow directly into the markets without first passing through the broker-dealer's systems. See Proposing Release at 4008.

result, the Rule would impose an array of risk management controls on broker-dealers providing access to exchanges or ATSs that effectively would preclude unfiltered access to these marketplaces. ITG is generally supportive of the Rule's intent to decrease the potential for financial, regulatory and systemic risks from sponsored access arrangements. As discussed below, however, there are certain provisions of the Rule that are either unclear, overly broad, or unnecessary. This letter discusses those provisions and suggests modifications to the Rule to eliminate the deficiencies.

I. Description of the Rule

The Rule would require a broker-dealer with "market access," or that provides a customer or any other person with access to an exchange or ATS through use of its market participant identifier ("MPID") 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 related to such business activity. The Rule defines "market access" as "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."[3] The Rule specifies that the risk management controls and supervisory procedures must be, among other things, reasonably designed to (1) systematically limit the financial exposure of the broker-dealer that could arise as a result of market access ("financial risk management controls and supervisory procedures"), and (2) ensure compliance with all "regulatory requirements" ("regulatory risk management controls and supervisory procedures").[4] The Rule defines "regulatory requirements" as "all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access."

Pursuant to the Rule, the required financial risk management controls and supervisory procedures in turn must be reasonably designed to (1) prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker-dealer and, where appropriate, more finely-tuned by sector,

[3] The Commission states in the Proposing Release that the proposed definition "encompasses trading in all securities on an exchange or ATS, including equities, options, exchange-traded funds, and debt securities." See Proposing Release at 4012. ITG requests that the Commission clarify whether the Rule covers trading in security futures products. While security future products are securities, they are unique in that the Commission and the Commodity Futures Trading Commission share jurisdiction in certain instances over them.

[4] Broker-dealers subject to the Rule would be required to preserve a copy of their supervisory procedures and a written description of their risk management controls as part of their books and records in a manner consistent with Rule 17a-4(e)(7) under the Exchange Act.

security, or otherwise by rejecting orders if such orders would exceed the applicable credit or capital thresholds, or (2) 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 required regulatory risk management controls and supervisory procedures in turn must be reasonably designed to (1) prevent the entry of orders unless there has been compliance with all regulatory requirements that must be satisfied on a pre-order entry basis, (2) prevent the entry of orders for securities for a broker-dealer, customer, or other person if such person is restricted from trading those securities, (3) restrict access to trading systems and technology that provide market access to permit access only to persons and accounts pre-approved and authorized by the broker-dealer, and (4) assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.

The risk management controls and supervisory procedures required by the Rule must be under the direct and exclusive control of the broker-dealer with market access. In addition, a broker-dealer with market access would be required to 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 would be required to review and document, no less frequently than annually and in accordance with written procedures, the business activity of the broker-dealer in connection with market access to assure the overall effectiveness of such risk management controls and supervisory procedures. Finally, the Chief Executive Officer (or equivalent officer) of the broker-dealer would be required, on an annual basis, to certify that such risk management controls and supervisory procedures comply with the Rule, and that the regular review described above has been conducted.

II. Comments

A. Definition of Regulatory Requirements

The Rule requires a broker-dealer with market access to have regulatory risk management controls and supervisory procedures that are reasonably designed to ensure compliance with all "regulatory requirements." ITG has several comments on the definition of "regulatory requirements." First, ITG believes that the Commission should consider which exchange rules are more properly within the ambit of an exchange's responsibility rather than a broker-dealer's responsibility, and should amend the Rule to make it clear that such rules are not covered by the definition. In this regard, ITG believes that exchanges are better equipped from a surveillance perspective to identify on a pre-trade basis whether orders sent to them potentially violate exchange rules pertaining

to trading halts and special order types.[5] For example, exchanges already have systems in place to prevent the execution of orders sent to them for securities subject to a trading halt. Moreover, the public and the markets are not harmed if broker-dealers route such orders to exchanges because the exchanges can prevent such orders from being executed.

Second, ITG believes that the requirement to screen orders to ensure compliance with all regulatory requirements is too broad and should be limited in scope.[6] In this regard, the Commission should specify which type of rules are covered by the definition of "regulatory requirements" that warrant screening on a pre-order basis. For example, the Commission indicates that broker-dealers subject to the Rule are responsible for preventing the entry of orders that violate Regulation NMS. ITG believes that in the case of Rule 611 of Regulation NMS (the trade-through rule), the Commission's position under the Rule is inconsistent with the requirements of the trade-through rule, which requires a "trading center" to establish written policies and procedures that are reasonably designed to prevent trade-throughs.[7] ITG notes that not all broker-dealers with market access as defined under the Rule are trading centers as defined in Regulation NMS, and thus should not be required to have procedures under the trade-through rule (but would be subject to best execution obligations).

ITG also questions whether broker-dealers subject to the Rule are in a position to monitor for violations of Exchange Act Rule 10b-5 on a pre-order entry basis. For example, it is often difficult for broker-dealers to monitor for market manipulation on a pre-order basis because market manipulation by definition is discovered by looking at a pattern of executed trades or cancelled and replaced orders or quotes (i.e., "spoofing"), particularly when a customer is executing orders through multiple broker-dealers and

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[5] ITG believes that ATSs should be treated differently than exchanges in this regard because they do not have the same regulatory responsibilities as an exchange nor do they have the same surveillance and monitoring resources. For example, in the event of a trading halt, an ATS would have to wait to receive the announcement from the relevant exchange just like any other broker-dealer. Therefore, an ATS would not be in a better position than any other broker-dealer in terms of enforcing the conditions of a trading halt.

[6] ITG also believes that the term "ensure" is too strong a term to use in the Rule because it could be read to imply that broker-dealers are guaranteeing the compliance of their clients with the relevant regulatory requirements, which is inconsistent with the broker-dealer regulatory scheme and likely not what the Commission intended. ITG therefore requests that the Commission replace the term "ensure" with the term "provide for."

[7] Rule 600(b)(78) of Regulation NMS defines a "trading center" as "a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any other broker or dealer that executes orders internally by trading as principal or crossing orders as agent."

market centers. Similarly, ITG questions how broker-dealers subject to the Rule would be in a position to monitor for insider trading on a pre-order entry basis. Insider trading, like market manipulation, is discovered after trades have been executed rather than on a pre-order entry basis. Moreover, while ITG recognizes the role broker-dealers play with respect to insider trading, exchanges and the SEC have been the parties that traditionally have conducted surveillance for insider trading.

B. Application of the Rule to Direct Market Access and Sponsored Access Arrangements

In addition to applying to a broker-dealer with market access, the Rule applies to arrangements in which a broker-dealer provides a customer or any other person with access to an exchange or ATS through use of the broker-dealer's MPID or otherwise (i.e., direct market access and sponsored access arrangements). The Commission in proposing the Rule states that it "is particularly concerned about the quality of broker-dealer risk controls in sponsored access arrangements, where the customer order flow does not pass through the broker-dealer's systems prior to entry on an exchange or ATS" and that it "understands that, in some cases, the broker-dealer providing sponsored access may not utilize any pre-trade risk management controls (i.e., 'unfiltered' or 'naked' access), and thus could be unaware of the trading activity occurring under its market identifier and have no mechanism to control it."[8] Accordingly, the Commission has determined through this rulemaking to effectively prohibit unfiltered sponsored access arrangements by requiring a broker-dealer's financial and regulatory risk management controls to be applied on an automated, pre-trade basis before orders are routed to an exchange or ATS.

ITG notes that direct market access and sponsored access arrangements have increased dramatically over the past decade as certain customers have sought a rapid means to send orders to market centers. These customers typically trade in high frequency and need quick, automated access to implement their trading strategies. Some customers seeking access arrangements prefer to have their orders sent to execution venues without handling by broker-dealer personnel in order to limit the persons who have knowledge of their trading methodologies and orders. In response to this need, many broker-dealers have implemented some form of sponsored access for clients who desire this type of arrangement. In and of itself, this development is a natural outgrowth of the increased automated nature of the securities markets. ITG recognizes, however,

[8] See Proposing Release at 4008. The Commission states that "[w]ith 'direct market access,' as commonly understood, the customer's orders flow through the broker-dealer's systems before passing into the markets, while with 'sponsored access' the customer's orders flow directly into the markets without first passing through the broker-dealer's systems." Id.

that automated access to market centers provided by broker-dealers to customers in a "light touch" manner raises legitimate issues for the SEC with respect to the controls in place at such broker-dealers. Pure unfiltered access could place the broker-dealer providing the access at risk and could create systemic risk for the markets because the broker-dealer is not able to provide controls on the order submission process. Thus, ITG supports the SEC's proposal to prevent unfiltered market access when the unfiltered access permits a customer to submit an order directly to a market center.

ITG, however, has concerns about the Rule's application to direct market access and sponsored access arrangements in which a broker-dealer is providing another broker-dealer with access to an exchange or ATS. For example, a broker-dealer may enter into a market access arrangement with its customers but provide the access by routing orders through another broker-dealer before the orders arrive at the execution venue. Such a structure may arise because the originating broker-dealer does not have the array of market access that the receiving broker-dealer possesses. In addition, these arrangements sometimes occur because the receiving broker-dealer can obtain orders from multiple broker-dealers in an amount sufficient to receive market volume discounts from the market centers to which it submits orders. These discounts can in turn be passed on to the originating broker-dealers. Sometimes the broker-dealers originating the orders in these arrangements are members of one or more of the underlying exchanges to which the orders are sent.

The broker-dealer that originates the orders is the party with the customer relationships and thus in the best position to implement and monitor the risk management controls. Accordingly, the originating broker-dealer should incur the policies and procedures obligations under the Rule. This is particularly the case when the broker-dealers originating the orders are members of the exchanges to which the access is being provided because they are familiar with the trading requirements and controls of the exchanges by virtue of their memberships. It would be duplicative and unnecessarily burdensome to require both broker-dealers in such arrangements to adhere to the Rule's requirements. Further, requiring both broker-dealers in such arrangements to adhere to the Rule's requirements would create unnecessary latencies in the market and discourage access arrangements between broker-dealers that enable firms to take advantage of volume discounts offered by exchanges. ITG therefore requests that the Commission clarify that the originating broker-dealer is the only party subject to the Rule's requirements in such arrangements.

If the Commission disagrees or is uncertain about our position, the Commission should allow the broker-dealers to decide by contract who has the responsibility in such

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arrangements. Such an approach is consistent with the approach the Commission has taken under Regulation SHO with respect to the locate requirement. In particular, the Commission has taken the position under Regulation SHO that an introducing broker can negotiate with its clearing broker as to who has the locate responsibility.[9] Moreover, ITG believes that such an approach does not diminish the Commission's concerns about market risk because the Commission and the SROs have jurisdiction over the broker-dealers in such arrangements and therefore can directly oversee and monitor the effectiveness of their risk management controls and supervisory procedures.

The Commission asks in the Requests for Comments section of the Proposing Release whether it should require broker-dealers that provide other persons with sponsored access to an exchange or ATS to have separate identifiers for each such person.[10] ITG believes that the Commission should not impose such an obligation for several reasons. First, it could potentially harm clients by destroying their trading anonymity. The attachment of an MPID to a particular client could disclose to other market participants that such client was behind an order. Even if other market participants could not figure out the identity of a client through that client's MPID, they could figure out trading patterns associated with a particular client's MPID.

Second, we believe that it would create an unnecessary and burdensome requirement for broker-dealers that under other recently proposed rules, may already be required to secure multiple MPIDs.[11] Third, it would force broker-dealers to allocate more money and resources to re-programming trade reporting and clearing systems to capture the multitude of MPIDs that broker-dealers would need to maintain for sponsored clients. Finally, we are unsure what purpose such separate identifiers would serve as the sponsoring broker-dealer is required to know the identity of the party for every order for which it provides access.

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[9] See Securities Exchange Act Release No. 50103 (Jul. 28, 2004), 69 FR 48008 (Aug. 6, 2004) at 48015.

[10] See Proposing Release at 4016.

[11] The SEC's proposal addressing non-public trading interest would require an ATS using its sponsoring broker-dealer's MPID to obtain a unique MPID for the ATS from the Financial Industry Regulatory Authority ("FINRA"). See Securities Exchange Act Release No. 60997 (Nov. 13, 2009), 74 FR 61208 (Nov. 23, 2009). Furthermore, FINRA's recently proposed Rule 5320 (Prohibition Against Trading Ahead of Customer Orders) provides that if a member firm structures its order handling practices in NMS stocks to permit its market-making desk to trade at prices that would satisfy customer orders held at a separate trading unit, then the member firm must, among other requirements, assign and use a unique MPID for the market-making desk. See Securities Exchange Act Release No. 61168 (Dec. 15, 2009), 74 FR 68084 (Dec. 22, 2009).

C. Certain Controls and Procedures under the Rule

As noted above, the Rule requires broker-dealers with market access to have controls and procedures 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-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. ITG believes that the condition to more finely tune credit or capital thresholds where appropriate is unclear. In particular, the provision already requires a broker-dealer to have controls and procedures reasonably designed to prevent the entry of orders that exceed pre-set credit or capital thresholds in the aggregate for each customer. With such a ceiling put in place, ITG is unsure of why or when a broker-dealer would need to finely tune its controls by sector, security, or otherwise. Accordingly, ITG requests that the Commission clarify this condition.

Further, the Rule requires broker-dealers with market access to have controls and procedures reasonably designed to assure that appropriate surveillance personnel receive immediate post-trade execution reports that result from market access. The Proposing Release does not describe the post-trade reports other than the Commission's expectation that broker-dealers would be able to identify the applicable customer associated with each execution report.[12] The Proposing Release states that the reports would provide surveillance personnel with important information about potential regulatory violations, and better enable them to investigate, report, or halt suspicious or manipulative trade activity, as well as provide the broker-dealer with more definitive data regarding the financial exposure faced by it at a given point in time.[13]

ITG believes that the Commission should provide clarification on the expected use of these reports. It is not practical to expect broker-dealers to conduct instant surveillance for all potential regulatory violations immediately after receiving the execution reports. Such execution reports should merely be used as another tool in the compliance and supervisory arsenal of broker-dealers and should not give rise to new and unrealistic expectations about the ability of broker-dealers to monitor all of a client's activity in real-time. Clearly, certain aspects of access arrangements warrant immediate attention, such as overriding of risk or trade limits or possible erroneous trades. Other aspects may not be cost effective to do on an immediate basis or not amenable at all to immediate post-trade surveillance. For example, a broker-dealer providing access may

[12] See Proposing Release at 4014.

[13] Id.

not be privy to a client's complete order flow or trading methodology, so that post-trade monitoring for many potential rule violations may be impossible in an immediate post-trade environment. Moreover, some violation of the securities laws, such as market manipulation, involve sophisticated trading on several different market centers and at different times. Again, it is unrealistic to expect broker-dealers to be able to monitor effectively for such conduct through post-trade execution reports of the orders of its market access clients.

D. Application of the Rule to ATSs

The Proposing Release asks whether an ATS in its capacity as a broker-dealer should be required to implement appropriate risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks, such as the legal and operational risks, associated with the non-broker-dealer subscriber's access to the ATS.[14] ITG believes that an ATS's broker-dealer sponsor should be required to implement such controls and procedures only with respect to orders received from non-broker-dealer clients. When receiving orders from non-broker-dealer clients, the ATS's sponsoring broker-dealer is the only broker-dealer in the chain of order flow from the client to the ATS. It seems reasonable to impose the Rule's requirements on that broker-dealer so that a market access client is not able to circumvent the risk controls required by the Rule. With respect to orders sent to an ATS by another broker-dealer, we believe as noted above that the broker-dealer originating the orders should incur the obligations under the Rule. When receiving orders from another broker-dealer, an ATS is acting primarily as an execution destination. The originating broker-dealer is the entity that is actually providing the market access to its clients. Accordingly, the originating broker-dealer should undertake the obligations imposed by the Rule.

E. CEO Certification

The Rule would require that a broker's Chief Executive Officer (or equivalent officer) certify on an annual basis that the broker's risk management controls and supervisory procedures comply with the Rule and that the broker conducted a regular review thereof. The Commission in the Proposing Release states that it is critical that broker-dealers with market access charge their most senior management with the responsibility to review and certify the efficacy of its controls and procedures at regular intervals.[15] We believe that this provision is overly burdensome and unnecessary.

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[14] See Proposing Release at 4016.

[15] See Proposing Release at 4015.

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FINRA members already are required by FINRA Rule 3130 to perform annual reviews of their supervisory systems and to obtain a certification from the CEO. We see no reason to load onto a firm's CEO this additional certification. We understand that the Commission and SROs in recent years have increasingly relied on senior management review of the performance of a broker-dealer's compliance function as a means to ensure that such function is given sufficient attention and resources. The addition of yet another CEO certification, which is somewhat redundant of other certifications provided by senior management of a broker-dealer, will only divert valuable legal, compliance, and supervisory resources from more meaningful projects to the certification process.

III. Conclusion

ITG appreciates the opportunity to comment on the Commission's proposal. While we are generally supportive of the Rule's intent to decrease the potential for financial or regulatory risks from sponsored access arrangements, we believe that our suggestions above will help fix and clarify the deficiencies we note in the Rule. If you have any questions related to our comment letter, please feel to contact me.

Sincerely,

P. Mats Goebels

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General Counsel
Investment Technology Group, Inc.

cc: Robert Cook
Division of Trading and Markets

James Brigagliano
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