REGULATORY REPORT CARD | March 2014

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AGENCY

US Securities and Exchange Commission (SEC)

Rule title
Risk Management Controls for Brokers or Dealers with Market Access

RIN	3235-AK53
Publication Date	November 15, 2011
Stage	Final

RULE SUMMARY

The rule restricts "naked" market access, i.e., direct customer access to Automated Trading Systems. The goal is to reduce systemic risk posed by "naked" trading, based on the presumption that erroneous trades may dramatically impact prices. The regulation requires brokers and dealers with direct access to markets to adopt, document, and maintain controls and procedures that would prevent entry of orders that appear erroneous or exceed preset credit or position limits. The controls and procedures must also ensure that orders cannot be entered unless all regulatory requirements that must be met prior to entry have been satisfied. The broker or dealer must evaluate the effectiveness of these controls annually.

COMMENTARY

The SEC largely justifies this regulation based on several high-profile incidents of erroneous trades that moved markets. It does not explain why brokers and dealers lack adequate financial incentives to implement cost-effective controls. In several places, the SEC acknowledges that these firms have a significant financial stake in preventing these trades and that many may already be in compliance. In fact, the rule mentions that there is already a private self-regulation initiative dealing with naked trading, yet it fails to explain how SEC's rule will improve on self-regulation measures. It never seems to realize that this admission undermines the claim that the regulation is needed and means that the benefits of the regulation are not as large as assumed. The benefit-cost analysis assesses some consequences of the regulation the SEC decided to adopt, without considering alternatives that may have had greater benefits or lower costs.

This rule's economic analysis was scored by a team of economists as the basis for Jerry Ellig and Hester Peirce's study, "SEC Regulatory Analysis: 'A Long Way to Go and a Short Time to Get There.'"
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OPENNESS	Score	Comments
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	4	1A
2. How verifiable are the data used in the analysis?	2	1B
3. How verifiable are the models and assumptions used in the analysis?	1	1C
4. Was the Regulatory Impact Analysis comprehensible to an informed layperson?	2	1D
Total Openness (Sum of 1–4)	9	

ANALYSIS	Score	Comments
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1	2A
6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	2	2B
7. How well does the analysis assess the effectiveness of alternative approaches?	0	2C
8. How well does the analysis assess costs and benefits?	1	2D
Total Analysis (Sum of 5–8)	4	

USE	Score	Comments
9. Does the proposed rule or the RIA present evidence that the agency used the Regulatory Impact Analysis?	1	3A
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	3B
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	3C
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	3D
Total Use (Sum of 9–12)	2	

Total Score	**15**	

This analysis was evaluated using the 2008–2012 scoring system, which evaluated regulatory analyses based on 12 criteria. This analysis was scored on a scale from zero to 60 points.

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Criterion	Score	Com. No.	Comment
OPENNESS			
1. How easily were the RIA, the proposed rule, and any supplementary materials found online?	4	1	A RIN search on regulations.gov immediately returns the Notice; a keyword search produces it only after narrowing the agencies to the SEC. The cost-benefit analysis is in the Notice. It is also on the SEC web page, via the "Regulations" link.
2. How verifiable are the data used in the analysis?	2	2	Salary data are sourced to an SEC document that is not linked, so it may or may not be public. Paperwork Reduction Act analysis cites SEC data as the source for the estimate of the number of affected firms; it is not clear if this is verifiable. Most other data is sourced to "discussion with industry participants" or "industry sources."
3. How verifiable are the models and assumptions used in the analysis?	1	3	Very little theory goes into the analysis of benefits or costs, and no published research is cited in support of any claims about cause and effect.
4. Was the analysis comprehensible to an informed layperson?	2	4	Cost-benefit analysis was relatively easy to read. Benefits were merely asserted, so it was hard to understand what the tangible benefits would be or how the regulation was necessary to produce them. Costs were more straightforward, if a bit tedious. Specialized jargon is a barrier for non-specialists.
ANALYSIS			
5. How well does the analysis identify the desired outcomes and demonstrate that the regulation will achieve them?	1		
Does the analysis clearly identify ultimate outcomes that affect citizens' quality of life?	4	5A	The analysis identifies reduced systemic risk and reduced risks to individual broker-dealers due to prevention of erroneous orders that could move markets. It also mentions increased investor confidence. Reduced risk to firms seems like a clear benefit. Benefits to the general public from reducing trading errors are assumed to be self-evident. "Increased investor confidence" is not defined or linked to any tangible benefit for investors or the economy.
Does the analysis identify how these outcomes are to be measured?	1	5B	There is no relevant content. None of the outcomes is measured or quantified. The discussion implies some things that could be measures, such as erroneous trades or greater market participation.
Does the analysis provide a coherent and testable theory showing how the regulation will produce the desired outcomes?	1	5C	The analysis merely asserts that the regulations will produce these benefits by reducing trading errors. The implicit theory is that, by banning "naked" market access, the rule will eliminate risks emanating from such trading. The analysis does not discuss whether filtered trading is safer.
Does the analysis present credible empirical support for the theory?	0	5D	There is little relevant content. There is some anecdotal evidence of erroneous trades, but no evidence that filtered access reduces errors.
Does the analysis adequately assess uncertainty about the outcomes?	0	5E	No uncertainty is acknowledged.

6. How well does the analysis identify and demonstrate the existence of a market failure or other systemic problem the regulation is supposed to solve?	2		
Does the analysis identify a market failure or other systemic problem?	4	6A	The implicit idea is that naked trading harms parties other than the ones participating in the trade because it moves market prices and makes them less accurate. It may also reduce market participation due to this risk. One must read very closely to find this.
Does the analysis outline a coherent and testable theory that explains why the problem (associated with the outcome above) is systemic rather than anecdotal?	2	6B	A cohesive theory would need to show that naked trading leads to these problems and that filtered trading has less incidence of these problems. The analysis only offers a claim that naked trading can have external effects. No theory is offered, beyond the tautology that the anecdotal mistaken trades would not have occurred if the regulation were in place. Undermining this assertion is an admission that "it is clearly in a broker or dealer's financial interest" to prevent erroneous errors that may expose the broker or dealer to substantial costs, which would seem to imply that firms have substantial incentives to adopt cost-effective safeguards. The preamble also notes that broker-dealers are legally responsible for all trading activity that takes place under their identifier. Perhaps there is an externality, but this is not even asserted.
Does the analysis present credible empirical support for the theory?	1	6C	The sole piece of evidence in the analysis that the regulation may address a significant problem is the statistic that naked access accounts for 38 percent of US equity trading. But this does not demonstrate that significant erroneous errors are a frequent or large problem. The analysis often asserts that many firms are already in compliance, without noticing that this means the problem is smaller than the SEC expects. The preamble says some exchanges provide searchable lists of erroneous trade cancellations (and provides a link to the NASDAQ one), "which indicate that erroneous trades occur with some regularity." Whether these trades all involve substantial risks is not clear.
Does the analysis adequately assess uncertainty about the existence or size of the problem?	0	6D	The problem is assumed to exist with certainty and to be widespread, based on a few anecdotes.
7. How well does the analysis assess the effectiveness of alternative approaches?	0		
Does the analysis enumerate other alternatives to address the problem?	0	7A	The benefit-cost analysis itself included no alternatives. The Reg Flex section asserts that the commission considered several options to reduce impact on small businesses but concluded that these were not necessary because the regulation is a performance standard with a great deal of compliance flexibility. The SEC apparently adopted a few alternative tweaks suggested by commenters, but these were not assessed in the analysis.
Is the range of alternatives considered narrow (e.g., some exemptions to a regulation) or broad (e.g., performance-based regulation vs. command and control, market mechanisms, nonbinding guidance, information disclosure, addressing any government failures that caused the original problem)?	0	7B	The alternatives mentioned in the Reg Flex section are small tweaks, and they were not really analyzed.

Does the analysis evaluate how alternative approaches would affect the amount of the outcome achieved?	0	7C	No actual analysis of the small business options is presented, just an assertion of what the commission concluded.
Does the analysis adequately address the baseline? That is, what the state of the world is likely to be in the absence of federal intervention not just now but in the future?	1	7D	The analysis asserts that many brokers or dealers likely already have controls in place that would comply with the regulation. This is implicitly presented as a reason costs may be lower than expected, but the analysis neglected to mention that this also reduces the benefits of the regulation.
8. How well does the analysis assess costs and benefits?	1		
Does the analysis identify and quantify incremental costs of all alternatives considered?	2	8A	The analysis estimates some compliance costs but not broader social costs. It notes that the regulation will increase trading costs for broker-dealers. However, it also states that many will probably bear little new cost since they are already in compliance. It asserts that allowing broker-dealers to delegate responsibility to customers who are broker-dealers would not affect costs materially. Costs of alternatives not estimated.
Does the analysis identify all expenditures likely to arise as a result of the regulation?	3	8B	The analysis estimates that upfront technology costs would total \$70 million, with \$65 million in ongoing annual costs. Legal and compliance cost would be \$44.3 million initially and \$47.9 million annually thereafter. It did not consider agency expenditures.
Does the analysis identify how the regulation would likely affect the prices of goods and services?	1	8C	The analysis acknowledges that the regulation will increase trading costs, but there is no discussion of how any costs (quantified or unquantified) would be passed on to traders.
Does the analysis examine costs that stem from changes in human behavior as consumers and producers respond to the regulation?	1	8D	The analysis notes that the regulation will increase latency times and reduce liquidity, and thus some market participants will lose trading opportunities. There is no estimate of the costs of this. The analysis asserts that there will be no effect on competition because the regulation does not create a substantial barrier to entry.
If costs are uncertain, does the analysis present a range of estimates and/or perform a sensitivity analysis?	1	8E	The SEC acknowledges that it does not know how many firms would need to update existing systems vs. build new systems from scratch. It provides an illustrative calculation assuming five percent of firms have to build new systems from scratch but does not say how likely or how accurate this is. Cost data submitted by commenters was regularly dismissed with the argument that the SEC calculations represent an average and that some firms' costs may be higher.
Does the analysis identify the alternative that maximizes net benefits?	0	8F	There is no relevant content. Benefits were not quantified.
Does the analysis identify the cost-effectiveness of each alternative considered?	0	8G	There is no relevant content. Benefits were not quantified.

Does the analysis identify all parties who would bear costs and assess the incidence of costs?	2	8H	The analysis states that some broker-dealers may already be in compliance but does not estimate how many. It is not clear how this acknowledgement affected the calculation of total costs. It also acknowledges that the burden may be relatively greater for small broker-dealers, but it does not calculate this.
Does the analysis identify all parties who would receive benefits and assess the incidence of benefits?	2	8I	Sometimes the analysis says broker-dealers will benefit; other times it implies the benefits are market-wide. There is no specific analysis for this.
USE			
9. Does the proposed rule or the RIA present evidence that the agency used the analysis?	1	9	It is clear from the notice that the SEC adopted the regulation in response to several instances of erroneous trading activity that moved markets and not because of any findings in the cost-benefit analysis. The analysis simply assesses some effects of the regulation the SEC decided to adopt. The SEC acknowledges that the benefit-cost analysis exists.
10. Did the agency maximize net benefits or explain why it chose another alternative?	0	10	The analysis did not calculate net benefits, and since it did not quantify benefits, it is not possible to calculate net benefits from the information in the analysis.
11. Does the proposed rule establish measures and goals that can be used to track the regulation's results in the future?	0	11	The SEC articulates no goals or measures and makes no commitment to assess the benefits or costs of this regulation in the future. The benefit-cost analysis is not complete enough to serve as a template for retrospective analysis.
12. Did the agency indicate what data it will use to assess the regulation's performance in the future and establish provisions for doing so?	1	12	The SEC requires firms to assess the effectiveness of their risk management controls and supervisory procedures. It also notes that some exchanges offer a public database of corrected erroneous trades. The internal reviews and exchange data could perhaps be used to partially assess the effectiveness of the regulations in preventing erroneous trades, but it would take some work to develop a framework for analyzing this.