National Exam Risk Alert

By the Office of Compliance Inspections and Examinations[1]

In this Alert:

Topic: *Regulatory concerns related to master/sub-account structures.*

Key Takeaways:

Master/sub-account trading arrangements can pose the following risks, among others:

Money laundering;

Insider trading;

Market manipulation;

Account intrusions and information security;

Unregistered broker-dealer activity and excessive leverage.

New Rule 15c3-5 requires broker-dealers to have controls and procedures reasonably designed to manage the financial, regulatory and other risks associated with providing a customer or other person with market access.

This alert highlights examination points of inquiry and compliance suggestions to address these risks.

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Master/Sub-accounts

I. Introduction

The Securities and Exchange Commission's ("Commission") National Exam Program ("NEP") has identified the master/sub-account trading model as a vehicle that could be used to further violations of the federal securities laws as well as other laws and regulations. In particular, misuse of the account structure raises significant regulatory concerns with respect to: (*i*) money laundering, (*ii*) insider trading, (*iii*) market manipulation, (*iv*) account intrusions, (*v*) information security, (*vi*) unregistered broker-dealer activity, and (*vii*) and excessive leverage (*e.g.*, inadequate minimum equity for pattern day traders).[2]

Generally, in the master/sub-account trading model, a top-level customer opens an account with a registered broker-dealer (the "master account") that permits the customer to have subordinate accounts for different trading activities ("sub-account"). In many, if not most, instances, the customer opening the master account is a limited liability company ("LLC"), limited liability partnership ("LLP") or similar legal entity or another broker-dealer with numerous other persons trading through the master account ("traders"). The master account will usually be subdivided into subunits for the use of individual traders or groups of traders ("sub-accounts"). In some instances, these sub-accounts are further divided to such an extent that the master account customer and the

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[2] Under NASD Rule 2520, the term "pattern day trader" means any customer who executes four or more trades within five business days. If day-trading activities do not exceed six percent of the customer's total trading activity for the five-day period, the clearing firm is not required to designate such account as pattern day traders. This rule applies to all broker-dealers that are FINRA members.

registered broker-dealer with which the master account is opened may not know the actual identity of the underlying traders. Nevertheless, the master account customer usually tracks the trading activities in each sub-account, and will often evaluate the account for risk and/or provide a sub-account with additional trading leverage. Although these arrangements may be used for legitimate business purposes, some customers who seek these master/sub-account relationships often structure their account with the broker-dealer this way in an attempt to avoid or minimize regulatory obligations and oversight.

Promoters of these trading arrangements, who may be customers or other entities, often target potential traders in both the US and abroad with the promise of increased leverage and lower capital contributions than these persons would otherwise be allowed as day traders at a registered broker-dealer. The sub-account traders then usually engage in day-trading and/or other leveraged trading activity, with the trades executed via trading systems or other platforms provided by the master account customer/owner, whom the registered broker-dealer has authorized to use its Market Participant Symbol (or MPID).

The Commission recently adopted Rule 15c3-5 ("Market Access Rule" or the "Rule") under the Securities Exchange Act of 1934 ("Exchange Act").[3] The Market Access Rule applies to broker-dealers with market access to an exchange or alternative trading system, as well as to broker-dealers that provide customers or other persons with access to trading securities directly on an exchange or alternative trading system through the use of the broker-dealer's MPID or otherwise.[4] Under the Rule, the broker-dealer is responsible for having risk management controls and supervisory procedures reasonably designed to ensure compliance with all laws, rules and regulations imposed under the federal securities laws or by self-regulatory organizations ("SROs") in connection with market access ("regulatory requirements").[5] Specifically, the Market Access Rule requires broker-dealers to have a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of this business activity associated with providing a customer or other person with market access, including restricting access to the broker-dealer's trading systems and technology that provide access to persons pre-approved and authorized by the broker-dealer.[6] Most of the provisions of the Market Access Rule became effective on July 14, 2011.[7]

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3 Exchange Act Release No. 63241 (Nov. 3, 2010), 75 FR 69792 (Nov. 15, 2010) ("Adopting Release"), *codified at* 17 C.F.R. §15c3-5.

4 Rule 15c3-5(a)(1), 17 C.F.R. § 240.15c3-5(a)(1) defines market access as: (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. *See also* Adopting Release at 69796-97.

5 Rule 15c3-5(c)(2), 17 C.F.R. § 240.15c3-5(c)(2). *See also* Adopting Release at 69797-98.

6 Rule 15c3-5(b), 17 C.F.R. § 240.15c3-5(b) .

7 The Commission extended the compliance date, until November 30, 2011, for all of the requirements of Rule 15c3-5 for fixed income securities, and the requirements of Rule 15c3-5(c)(1)(i) for all securities. Rule 15c3-5(c)(1)(i) requires that the risk management controls must be reasonably designed to: "[p]revent 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."

The master/sub-account structure creates potential risks of noncompliance with legal requirements.

One of the most significant risks associated with these arrangements is that, many times, the registered broker-dealer obtains and maintains information only with respect to its customer, the owner of the master account (*i.e.*, the LLC or LLP). As mentioned above, because sub-accounts may be further divided, the broker-dealer may not know who is utilizing its MPID and trading in the sub-accounts. This lack of information may expose the registered broker-dealer to legal and reputational risks. The Market Access Rule is intended in part to address these risks by requiring broker-dealers to establish, document and maintain a system of risk management controls and supervisory procedures that are reasonably designed, among other things, to ensure compliance with all regulatory requirements that are applicable in connection with market access.[8]

Identified below are certain risks associated with the master/sub-account trading model. Failing to reasonably address these risks could place the broker-dealer in violation of the federal securities laws and rules thereunder, including the Market Access Rule, as well as applicable SRO rules.

Money Laundering, Terrorist Financing and Other Illicit Activity – The Bank Secrecy Act ("BSA"),[9] initially adopted in 1970, establishes the basic framework for anti-money laundering ("AML") obligations imposed on financial institutions.[10] The BSA, as amended, is intended to facilitate the prevention, detection, and prosecution of money laundering, terrorist financing, and other financial crimes. Among other things, the BSA requires broker-dealers to: (*i*) establish and implement an effective AML program,[11] (*ii*) establish a Customer Identification Program ("CIP"),[12] and (*iii*) monitor, detect and file reports of suspicious activity (the "SAR Requirement").[13] Moreover, Exchange Act Rule 17a-8 requires broker-dealers to comply with the reporting, recordkeeping and record retention requirements in regulations under the BSA.[14]

On September 1, 2010, as part of concurrent enforcement actions with the Financial Crimes Enforcement Network of the Department of the Treasury,[15] the Commission found that Pinnacle Capital Markets violated Exchange Act Section 17(a) and Rule 17a-8 thereunder by

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8 Adopting Release at 69797-98. The required controls and procedures would need to adapt as regulatory requirements applicable to market access change. *Id*.

9 Currency and Foreign Transactions Reporting Act of 1970, (commonly referred to as the Bank Secrecy Act), 12 U.S.C. § 1829b, 12 U.S.C. §§ 1951-1959, and 31 U.S.C. § 5311-5330.

10 31 C.F.R. § 1000-1099.

11 The BSA requires that broker-dealers establish AML programs that include, at a minimum, (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. 31 U.S.C. § 5318(h). A broker-dealer is deemed to have complied with this AML program requirement if the broker-dealer adopts an AML program pursuant to the rules of a self-regulatory organization. *See* 31 C.F.R. § 1023.210(b)(2). FINRA Rule 3310, as well as other SRO rules, requires broker-dealers to establish such a program.

12 31 C.F.R. §1023.220.

13 31 C.F.R. § 1023.320.

14 17 C.F.R. §240.17a-8.

15 *See In the Matter of: Pinnacle Capital Markets, LLC*, FinCEN Matter No. 2010-4 (Sept. 1, 2010).

failing to document accurately its customer verification procedures.[16] Pinnacle held master omnibus accounts for foreign entities, which in turn were subdivided into sub-accounts for other foreign entities. The holders of these sub-accounts were then able to conduct transactions directly in the US securities markets. The Commission found that Pinnacle treated these sub-account holders in the same manner as it did its regular account holders, allowing them to use direct market access software to enter securities trades directly and instantly through their own computers. The Commission concluded that the sub-account holders were Pinnacle's customers for purposes of the CIP rule because the sub-account holders effected securities transactions directly and without the intermediation of the master account holders. The Commission found that Pinnacle did not accurately document its CIP as required by the CIP rule, because Pinnacle had not identified the customer sub-account holders or verified their identities. As a result of this and other conduct, Pinnacle was found to have willfully violated Section 17(a) of the Exchange Act and Rule 17a-8 thereunder.

Risk: If money laundering, terrorist financing or other suspicious activity (such as the activity detailed below) is occurring through a customer's master/sub-account, it may be difficult for the broker-dealer to identify who is responsible for such activity or whether suspicious activity is the result of one person or many persons who have authority to trade in the accounts. As a result, these relationships may make it difficult for a broker-dealer to adequately monitor for suspicious activity, and therefore to comply with the SAR Requirement.

A broker-dealer must remain cognizant of its obligations under the CIP rule with respect to master/sub-account arrangements, as there are instances when the CIP rule may require identification and verification of sub-account holders.[17] Where a sub-account holder is the broker-dealer's "customer" for purposes of the CIP rule, the broker-dealer must treat the sub-account accordingly.[18] For example, as in Pinnacle, where a broker-dealer has treated a sub-

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16 *In the Matter of Pinnacle Capital Markets LLC and Michael A. Paciorek*, Exchange Act Release No. 62811 (Sept. 1, 2010) (settled administrative proceeding); *In the Matter of: Pinnacle Capital Markets,LLC,* FinCEN Matter No. 2010-4 (Sept. 1, 2010)(concurrent FinCen action). The Commission has brought a number of other actions to enforce compliance by brokers and dealers with regulations under the BSA pursuant to Section 17(a) of the Exchange Act and Rule 17a-8 thereunder. *See e.g., In the Matter of E*Trade Clearing LLC and E*Trade Securities LLC*, Exchange Act Release No. 58250 (Jul. 30, 2008); *In the Matter of Crowell, Weedon & Co.*, Exchange Act Release No. 53847 (May 22, 2006).

17 This alert is not intended to be a comprehensive review of a broker-dealer's AML obligations generally, or specifically with respect to master/sub-account relationships. Other AML obligations may require a broker-dealer to obtain information regarding sub-account holders, including, among other things, the due diligence obligations for private banking accounts and for correspondent accounts for foreign financial institutions, and requirements relating to the prohibition on correspondent accounts for foreign shell banks. *See, e.g.*, 31 C.F.R. 1010.610, 1010.620, and 1010.630. *See, also*, Guidance on Obtaining and Retaining Beneficial Ownership Information, Exchange Act Release No. 61651 (Mar. 5, 2010).

18 *See, e.g.*, 31 C.F.R. §1023.100(d) (defining a "customer" for purposes of the CIP rule as a person who opens a new account); 31 C.F.R. §1023.220(a)(2)(ii)(C) (additional verification requirements for certain customers (*i.e.*, customers that are not individuals); Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (31 CFR 103.122) (Oct. 1, 2003) *available at* http://sec.gov/divisions/marketreg/qa-bdidprogram.htm (Question and Answer ("Q&A") that addressed the non-exclusive circumstances under which a broker-dealer could treat an omnibus account holder as the only customer for the purposes of the CIP rule and would not also be required to treat the underlying beneficial owner as a customer. Among other things, the Q&A contemplated a scenario in which all securities transactions in the omnibus account or sub-account would be initiated by the financial

account owner as its own customer (i.e., sub-account owner effects transactions directly with the broker-dealer and without the intermediation of the master account owner), the broker-dealer has an obligation to identify and verify the identities of such sub-account holders as required by the CIP rule.

Furthermore, a broker-dealer's CIP must address situations where, based on the broker-dealer's risk assessment of a new account opened by a customer that is not an individual, the broker-dealer will obtain information about individuals with authority or control over such account.[19] *This verification method applies when the broker-dealer cannot verify the customer's true identity using the documentary or non-documentary verification methods described in the CIP rule.*[20] *This may require a broker-dealer to obtain information about and verify the identity of a sub-account holder where the broker-dealer cannot otherwise verify the identity of the master account holder.*

Even absent a CIP obligation, a broker-dealer's other AML obligations still apply, including the SAR Requirement. Among other things, a broker-dealer's AML program should evaluate the risks that may be presented by such master/sub-accounts. Specifically, as part of a broker-dealer's AML Program, a broker-dealer should establish and maintain customer due diligence procedures that are reasonably designed to identify and verify the identity of sub-account holders, as appropriate, based on the broker-dealer's evaluation of risks presented by such a master account.[21] *A broker-dealer's acceptance of master/sub-account business may be higher risk for the reasons detailed above.*

Insider Trading – Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security.[22] Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information. The Commission staff is concerned that customers with master/sub-account arrangements may seek to use them as vehicles for insider trading schemes.

The regulatory requirements provisions of the Market Access Rule include a requirement that a broker-dealer's risk management controls and supervisory procedures are reasonably designed to "prevent the entry of orders for securities that the broker-dealer, customer, or other person …is restricted from trading."[23]

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intermediary holding the omnibus account, and the beneficial owner of the omnibus account or sub-account would have no direct control of the transactions effected in the account.).

19 31 C.F.R. §1023.220(a)(2)(ii)(C). As discussed *infra* note 32 and accompanying text, SRO rules have independent due diligence and "know your customer" obligations that may apply.

20 *Id.*

21 *See, e.g.*, Guidance on Obtaining and Retaining Beneficial Ownership Information, Exchange Act Release No. 61651 (Mar. 5, 2010).

22 *See, e.g., United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997).

23 17 C.F.R. §240.15c3-5(c)(2)(ii).

Risk: Insider trading may be conducted through a sub-account to try to avoid detection. The master account owner (if not a registered broker-dealer) may not be subject to supervisory obligations under the securities laws for the activities of the sub-accounts for compliance with insider trading rules. However, the registered broker-dealer carrying the master account does have certain obligations.[24] *While these accounts may be visible to investigators after the occurrence of possible insider trading through information requests by self-regulatory organizations or the Commission under Exchange Act Rule 17a-25,*[25] *any weaknesses in front-line monitoring by a broker-dealer may create opportunities for abuse.*

If a broker-dealer offering its customers master accounts does not have reasonably-designed controls and procedures to prevent unlawful trading, there may be significant legal and reputational risk for the broker-dealer. Reasonable controls and procedures should be designed to address factors such as the high volume of transactions flowing through these accounts and the lack of knowledge as to who is actually doing the trading. For example, broker-dealers may need to design procedures to identify patterns of trading that may indicate potential misuse of nonpublic information, and consider whether further due diligence as to the identity of the trader is necessary. Broker-dealers offering master accounts should consider surveilling the trading activity in master accounts and sub-accounts against their "grey list" and/or "restricted list," and for the purpose of identifying unusual trading ahead of major market announcements or of highly profitable trading. Such activity could indicate the possibility of misuse of inside information. Broker-dealers should also consider the kind of appropriate due diligence needed to identify when the ultimate customer is an insider of a corporation and may be subject to trading restrictions in that corporation.

Market Manipulation – Market manipulation refers to intentional conduct designed to deceive investors by controlling or artificially affecting the price of a security.[26] Manipulation may involve a number of techniques to affect the supply of, or demand for, a security. They include: spreading false or misleading information about a company, improperly limiting the number of publicly-available shares, rigging quotes, or pricing trades to create a false or deceptive picture of the demand for a security. Those who engage in manipulation are subject to various civil and criminal sanctions. As with insider trading, the Commission staff is concerned that master/sub-accounts arrangements could be vehicles for market manipulation schemes.

Risk: A sub-account trader may open multiple accounts under a single master account or accounts under different master accounts and at different broker-dealers. The trader could effect trades on both sides of the market to manipulate a stock by entering orders to drive the price up, mark the close, or engage in other manipulative activity with minimal chance of detection. Such conduct may create the false appearance of activity or volume and can

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[24] *See, e.g.*, Rule 15(g), 17 C.F.R. §240.15(g)(policies and procedures reasonably designed to prevent misuse of material, nonpublic information by the broker-dealer or associated persons); NASD Rule 3010 (supervision generally); 31 C.F.R. § 1023.320 (obligation to monitor, detect and file reports of suspicious activity).

[25] 17 C.F.R. §240.17a-25. The information provided under Rule 17a-25 is commonly referred to as the Bluesheets. While Bluesheets may not directly reveal which sub-accounts were responsible for individual trades, that information should be obtainable by inquiry or subpoena to the master account owner.

[26] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

therefore fraudulently influence the price of a security. In addition, some bad actors may be engaged in account intrusions to further their manipulative conduct. Broker-dealers offering customers master accounts should apply their market manipulation surveillance parameters to trading activity at both the master account and sub-account levels.

Information Security – Information security means protecting information and information systems from unauthorized access, use, disclosure, disruption, modification, perusal, inspection, recording or destruction. The Commission staff has observed that broker-dealers, master account owners and sub-account traders could be vulnerable to breaches of information security due to weak controls. This vulnerability implicates the Market Access Rule requirement that broker-dealers "establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks" of providing market access to any other person.[27]

Risk: If a broker-dealer does not have appropriate controls over access to a master account, the broker-dealer may lack means to protect itself, the master account/sub-account owners, and its other customers from unauthorized access and use. Although hacking is a potential risk for any broker-dealer, a master/sub account structure poses a greater risk of hacking based on the risk that a larger population of persons with access to a broker-dealer's trading systems is more likely to include either bad actors or persons who are careless about information security.

Under a scenario in which the master account owner is the beneficial owner of not only the master account but also the various sub-accounts, the broker-dealer only knows the master account owner as its customer. As illustrated by a number of Commission enforcement actions, various forms of electronic account intrusion are a serious risk for broker-dealers and their customers,[28] and broker-dealers that permit master/sub-account arrangements must take reasonable measures to address this risk.

Master/sub-account relationships could also present a risk to informational national security if multiple sub-accounts, held through one or many different customers' master accounts, are used to conduct a single or multi-source cyberattack on a systemically important financial institution, such as the broker-dealer carrying the master account, a market utility linked to the broker-dealer or to the master account, such as a clearance or settlement system, or a counterparty of the broker-dealer or master account. While the NEP staff has not observed indications of such an attack, the consequences of such an attack could be severe, for the host broker-dealer as well as for the securities markets generally.

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[27] Rule 15c3-5(b), 17 C.F.R. § 15c3-5(b). This vulnerability could also implicate Rule 15c3-5(c)(2)(iii), 17 C.F.R. § 15c3-5(c)(2)(iii), which specifies that the required risk management controls and supervisory procedures should be reasonably designed to, *inter alia*, "restrict access to trading systems and technology that provide market access to persons and accounts pre-approved and authorized by the broker or dealer."

[28] *See, e.g., SEC v. Dorozhko*, Litigation Release No. 21465 (Mar. 29, 2010)(summary judgment against computer hacker for insider trading); *SEC v. Marimuthu, et al.*, Litigation Release No. 20037 (Mar. 12, 2007)(offshore hackers charged with account intrusion into online accounts and market manipulation); *SEC v. Dinh*, Litigation Release No. 18401 (Oct. 9, 2003)(allegations that hacker broke into investor's online account and placed unauthorized buy orders).

Broker-dealers offering customers master accounts may consider applying information security parameters and triggers to ensure that the trading activity and volume flowing through the master account do not result in undue added operational risk to the broker-dealer. In addition, the broker-dealers may require master account owners to implement controls to prevent the use of technology for inappropriate purposes.

Unregistered Broker-Dealer Activity – Section 15(a) of the Exchange Act makes it unlawful for any broker or dealer to effect any transaction in, or induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered with the Commission. The staff is concerned that broker-dealers offering master/sub-account arrangements may provide an avenue for unregistered broker-dealer activity, in which an LLC, LLP or other entity solicits customers to trade through the unregistered broker-dealer's master account while taking trading commissions or other compensation from the sub-account traders. Indeed, the Commission has recently brought actions against persons opening master accounts through a registered broker-dealer and then giving day traders access to the securities markets through sub-accounts. [29]

Risks: As illustrated in actions against Tuco Trading, LLC and Warrior Fund, LLC, many master/sub-account arrangements may permit the master account owner, and possibly a sub-account owner, to act as unregistered broker-dealers in violation of Section 15(a) of the Exchange Act. In addition, the registered broker-dealer with which an unregistered broker opens an account may also have liability for aiding and abetting in the activities of the unregistered broker-dealer's registration violations.

In exercising its "know your customer" reasonable diligence,[30] a broker-dealer offering customers master accounts should understand the relationship that exists between the master account and the sub-account traders. For example, if the master account is identified by the broker-dealer's customer as a proprietary account, the broker-dealer should endeavor to obtain and review valid partnership or employment agreements to evidence that the relationship between the master account customer and the sub-account is an employee or partnership relationship rather than a customer relationship.

Excessive Leverage and Others Risks – In addition to the risks identified above, market participants and sub-account traders are also exposed to a number of other risks as a result of abusive practices facilitated by the master/sub-account trading model, including being inappropriately used to offer excessive leverage.

Risks: In addition to unregistered broker-dealer activity, Tuco Trading, LLC and Warrior Fund, LLC, illustrate that master/sub-account arrangements also can be inappropriately used to offer excessive leverage to pattern day-traders who may have inadequate equity balances for such leverage. Additionally, staff continues to have a concern that the master/sub-account

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29 *See In the Matter of Tuco Trading, LLC and Douglas G. Frederic*, Litigation Release No. 20500 (Mar. 18, 2008); *In the Matter of Warrior Fund, LLC*, Exchange Act Release No. 61625 (Mar. 2, 2010).

30 The "know your customer rule" has long applied to most broker-dealers under New York Stock Exchange Rule 405(1). That rule, now enforced by FINRA, will soon be supplanted by FINRA Rule 2090, which takes effect July 9, 2012. *See* Securities Exchange Act Release No. 63325 (Nov. 17, 2010), 75 FR 71479 (Nov. 23, 2010) (Order Approving Proposed Rule Change; File No. SR-FINRA-2010-039). FINRA Rule 2090 is substantially the same as NYSE Rule 405(1). *See* FINRA NTM 11-25 (May 2011) at 2.

trading model may be used by master account owners as a means to defraud traders who contribute money in order to obtain market access to trade.[31]

II. The National Exam Program will examine for compliance with the Market Access Rule as a means to combat violative activity in the master/sub-account trading model.

With the adoption of the Market Access Rule, broker-dealers that provide market access are required to establish, document, and maintain a system of risk management controls and supervisory procedures that, among other things, is reasonably designed to systematically limit the financial, regulatory and other risks to the broker or dealer that could arise as a result of market access to an exchange or ATS, and ensure compliance with all regulatory requirements that are applicable in connection with market access.[32] In examining for compliance with the Market Access Rule, the staff intends to scrutinize

> (1) the system of risk management controls and supervisory procedures that addresses master account customers to which a broker-dealer offers market access, as defined in the Market Access Rule, and
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> (2) whether, in accordance with such controls and procedures, a subject broker-dealer is appropriately vetting the master account customer and sub-accounts identified as customers engaged in the trading business, or proprietary accounts, and individual traders with access to the broker-dealer's MPID, trading system and technology providing market access.

The following are examples of effective practices to evidence due diligence that the staff has observed when examining for reasonable controls and procedures in similar contexts,[33] as well as illustrations of types of controls that firms might apply in order to comply with the controls and procedures requirements of the Market Access Rule:[34]

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31 For example, in the *Tuco Trading* case, the Commission successfully sought a federal court permanent injunction from future violations of the federal securities laws, based on its allegation that the firm inaccurately reported equity balances to the traders and had used millions of dollars of the traders' equity to pay for the firm's expenses, which was not disclosed to the traders. These unregistered broker-dealers offering master-sub-account arrangements, even with adequate disclosure, still expose the traders to the risk of losing all of their capital contributions and profits based on the actions of the LLC, LLP or other entity or the actions/losses of fellow traders.

32 Rule 15c3-5(b) and (c)(2), 17 C.F.R. § 15c3-5(b) and (c)(2).

33 *E.g.*, compliance with Exchange Act 15(g)'s requirement that broker-dealers have controls and procedures reasonably designed to prevent insider trading; compliance with supervisory obligations under the federal securities laws.

34 These examples are not intended to be exclusive. Firms may demonstrate to the examination staff that they have acceptable alternative ways to comply with the Market Access Rule.

- To evidence that the subject broker dealer has performed[35] appropriate suitability, know-your-customer and other due diligence on the master account holder and traders to whom market access (with an MPID or similar arrangements) has been provided based on the broker-dealer's risk assessment of the business activity: (i) obtaining and maintaining the names of all traders authorized to trade with the broker-dealer's MPID in each sub-account; (ii) verifying through documentation the identities of all such traders, including fingerprints if appropriate, background checks and interviews; and (iii) periodically checking the names of all such traders through criminal and other data bases such as, in the case of foreign nationals, the Special Designated Nationals List of the Office of Foreign Assets Control of the United States Treasury Department;
- Monitoring trading patterns in both the master account and sub-account levels for indications of insider trading, market manipulation, or other suspicious activity;
- Physically securing information of customer or client systems and technology;
- Establishing trader validation requirements (*e.g.*, minimum procedures for effective password management, IP address identification, and other mechanisms that validate the trader's identity);
- Tracking and logging incidents of penetration-of-system attempts by outside parties without authority;
- Determining that traders who have access to the broker-dealer's trading system and technology have received training in areas relevant to their activity, including market trading rules and credit;
- Regularly reviewing the effectiveness of all controls and procedures around sub-account due diligence and monitoring; and
- Creating written descriptions of all controls and procedures around sub-account due diligence and monitoring, including frequency of reviews, identity of who is responsible for conducting such reviews, and a description of the review process.

In the course of these examinations, the broker-dealer providing access will be asked to supply information regarding the nature of its risk assessment and to support its conclusions. The staff may request records evidencing whether persons associated with the master account customer, who are provided access to the market through the broker-dealer's trading systems or other technology, are not themselves customers for purposes of Exchange Act Rule 15c3-3. For example, the subject broker-dealer may supply (i) partnership or shareholder agreements signed by the person at the sub-account level to whom market access is provided, or (ii) documentary evidence among the various persons to whom access or technology is provided that sufficiently demonstrates that the relationship between the customer and the sub-account traders is an employment or trading relationship rather than a customer relationship.

III. Conclusion.

While master/sub-account arrangements may be used for legitimate business purposes, the NEP has also identified a number of serious abusive practices that this account structure can facilitate. Broker-dealers offering master/sub-accounts have an obligation under the Market Access Rule to

[35] The Market Access Rule provides that broker-dealers may have a reasonable, written allocation arrangement under certain circumstances with a customer that is a registered broker-dealer for specific controls and procedures Rule 15c3-5(d)(1), 17 C.F.R. § 15c3-5(d)(1).

establish, document and maintain a system of risk management controls and supervisory procedures that are reasonably designed, among other things, to ensure compliance with all regulatory requirements that are applicable in connection with market access. In this Alert we have described certain risks that broker-dealers that offer the master/sub-account trading model to customers should consider in designing such controls and procedures. We have also highlighted certain practices that we believe could be helpful to firms in meeting their obligations under the Market Access Rule.