

Risk Management for Brokers and Intermediaries

Risk Assessment of Exchanges/Clearinghouses

Brokers/intermediaries should consider information available about the risks of trading on a particular exchange/clearinghouse prior to executing trades on such market. Such risks should be monitored on an ongoing basis.

Among the factors that might be appropriate to consider in determining whether to transact on a particular exchange/clearinghouse are the quality of the regulatory and oversight system of the exchange/clearinghouse; the applicable financial integrity system, relevant customer protection mechanisms (e.g., segregation requirements, account insurance, guarantees or compensation funds); the source and liquidity of relevant financial support; the margining and settlement system; the ability to transfer positions and property in the event of a default; the ability of the exchange/clearinghouse to impose capital requirements on its members, to require its members to increase their capital, or to assess its members; the description of the clearing members and/or shareholders; and the regulatory and legal system including applicable bankruptcy laws in the relevant jurisdiction.

Risk Assessment of Clearing Brokers

Brokers/intermediaries should consider the financial condition, operational capacity and other material risks of the clearing brokers through which they execute and/or clear transactions on those markets where they do not clear directly (or through affiliates). The primary factors to consider in evaluating a clearing broker should include, among others, its credit standing, capital and financial condition, the exchanges/clearinghouses of which it is a member and the type of firm (for example, a bank, securities broker, insurance company or an affiliate thereof). Other factors that might also be considered include the clearing broker's management experience and capabilities, its margin policies and customer credit procedures, its operational capacity, risk management systems and disaster recovery procedures and whether or not it engages in proprietary trading. Based on the results of this consideration, brokers/intermediaries may consider implementing procedures, to be applied in appropriate instances, to protect against the risks of clearing through certain clearing brokers or categories of clearing brokers.

Those brokers/intermediaries with substantial exposure to clearing brokers as a result of the brokers/intermediaries' trading activities with such clearing brokers should establish and maintain back-up clearing relationships with other clearing brokers to be utilized in emergency situations. Such relationships should include completed contractual arrangements with such back-up clearing brokers and periodic testing of procedures for transfers of positions and property and continuation of trading.

Risk Assessment of Depositories

Brokers/intermediaries should consider and monitor on an ongoing basis the depositories utilized for custody of customer property. Among the factors that may be considered are the financial condition of the depositories, including their credit standing, and the nature of their operations.

Risk Management of Customers

Risk Assessment of Customers

A broker/intermediary, prior to establishing a relationship with a customer, should assess the risks of doing business with that customer and should regularly monitor these risks throughout the term of the relationship with the customer. In general, a broker/intermediary's consideration should focus on the following areas:

- (a) the nature of the customer (e.g., institutional or retail) and its corresponding level of experience and sophistication;
- (b) the creditworthiness of the customer, as measured by established credit policies and procedures of the broker/intermediary; and
- (c) the authority (including apparent authority) of the customer to conduct its proposed trading activities, including the customer's legal authority and the capacity of the individuals responsible for the trading.

Review of customers' financial condition, and related decisions with respect to customers, should be conducted by persons and business units within the broker/intermediary (a) that are independent of the sales personnel and (b) whose compensation is not directly related to the volume or profitability of trading conducted by customers.

Customer margin requirements and, where appropriate, position limits should be established at levels that are adequate, in the judgment of the broker/intermediary, to protect the broker/intermediary against reasonably foreseeable risks arising from the customer's trading activities. Customers' significant market exposures should be reviewed on at least a daily basis and, where necessary for the protection of the broker/intermediary, the broker/intermediary should call for additional collateral, modify margin requirements or position limits, require customers to reduce the size of existing positions or take other appropriate actions.

Brokers/intermediaries should establish and enforce policies and procedures regarding the prompt collection of customer margin (other than in the case where there are appropriate credit arrangements in place) and the liquidation of customer accounts (or other appropriate action) where necessary.

Brokers/intermediaries should establish and enforce procedures regarding account opening and trading by omnibus and introduced accounts, recognizing the potential exposure to the broker/intermediary that may arise from such accounts.

Brokers/intermediaries should establish risk management procedures for trading by affiliates carried on their books. Such procedures should include, among others, position limits for affiliates' trading activities based on their financial status.

Legal Relationships with Customers

Brokers/intermediaries should prepare and utilize written agreements with their customers that clearly delineate the respective rights and obligations of the brokers/intermediaries and their customers. Such agreements should provide a basis for allocating between brokers/intermediaries and their customer's responsibility for all material aspects of their relationships and risk exposures and should take into account the particular requirements of each customer and its relationship with the broker/intermediary.

A broker/intermediary should provide its customers, upon request, with information regarding the financial status of the broker/intermediary (subject to appropriate confidentiality considerations) and the identities of depositories and clearing brokers utilized by the broker/intermediary.

In general, where a customer seeks to obtain beneficial treatment for positions held for hedging, arbitrage or other purposes, a broker/intermediary should be able to rely on representations provided by its customer that the positions are eligible for such treatment. A broker/intermediary should establish and enforce procedures, however, to deal with those situations in which the broker/intermediary forms a judgment (based on information known to the broker/intermediary) that such representations are not accurate. Such

policies or procedures might include making appropriate inquiries of the customer's senior management or requiring the customer to provide documentation to support its representations.

Protection of Customer Property; Financing of Customer Margin

Brokers/intermediaries should establish and enforce appropriate policies and procedures, taking into account applicable laws and regulations, to identify and protect customer property in their custody or control. Such policies and procedures might include segregation or other separation of customer property from proprietary property, maintenance of appropriate books and records identifying customer property, maintenance of adequate capital, and/or restrictions on the investment or other use of customer property.

Except where appropriate and legally permissible credit arrangements have previously been established, brokers/intermediaries should promptly collect margin from their customers. In those instances in which margin is not collected within a reasonable period of time, appropriate adjustments, which may include requirements for financial reserves or additional collateral, should be imposed to reflect the potential exposure of brokers/intermediaries to their customers. The adequacy of these arrangements should be regularly re-evaluated in light of changing market conditions and should be adjusted as necessary.

Internal Controls

A broker/intermediary engaging in customer and proprietary trading should establish and enforce appropriate policies and procedures to identify customer property and to protect it against risks arising as a result of its proprietary trading activities. Such policies and procedures should include the maintenance of appropriate books and records that, among other things, separately identify customer and proprietary accounts and active monitoring of proprietary trading activities, including, if appropriate, the establishment of risk-based position limits.

Brokers/intermediaries should conduct regular internal reviews of their customer and proprietary accounts, including record-keeping and other account maintenance matters, to monitor the broker/intermediary's compliance with applicable laws and regulations and internal policies and procedures. Such reviews should be conducted by personnel who are independent of proprietary traders and personnel responsible for customer relationships.

The Board of Directors or senior management of a broker/intermediary should establish general risk management guidelines and procedures for proprietary trading activities of the broker/intermediary, including instruments and strategies, position and trading limits for trading desks, business units and/or individual traders, periodic stress testing and cash flow and "value at risk" analyses. Compliance with such procedures and limits should be monitored regularly by personnel independent of proprietary traders. The Board of Directors or senior management should periodically review and modify such guidelines and policies, as necessary or appropriate.

Adequate separations should be imposed between (a) back office personnel responsible for trade reconciliation, margin, position limits, preparation and maintenance of books and records and other similar matters as well as compliance personnel, risk management personnel and treasury or funding personnel, and (b) personnel responsible for customer relationships or proprietary trading. The authority of appropriate personnel in these areas should be clearly established.