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SEC REVISITS EQUITY MARKET STRUCTURE IN CONCEPT RELEASE AND RULE PROPOSALS

In a new initiative, the SEC seeks public comment on regulatory changes it is considering to improve equity market structure. The subjects on which comments are sought include high-frequency trading, dark liquidity, sponsored access, and flash orders.

By Mark D. Perlow and C. Dirk Peterson *

The Securities Exchange Act of 1934 grants the Securities and Exchange Commission broad oversight and rule-making authority to promote fair and competitive markets as well as interaction and competition among orders trading through increasingly dispersed markets. However, these goals are sometimes incongruous in that competition among markets can impede the interaction of orders. The historical challenge for the SEC has been to balance these two sometimes conflicting goals into a unified, national market system (an "NMS"). The SEC has tried to fulfill this mandate with a series of rule-makings over the past 35 years, culminating nearly five years ago in a comprehensive set of market, trading, and reporting rules for publicly traded equity securities codified in Regulation NMS.

Most recently, on January 14, 2010, the SEC revisited issues raised and addressed by Regulation NMS in a concept release intended to elicit public comment on a broad range of questions relating to the efficiency and fairness of the public equity markets (the "Concept Release").[1] Shortly after publishing the Concept Release, the SEC also published a release proposing a new risk management rule that would require firms that sponsor trading access to exchanges and alternative trading systems ("ATSs") to establish (and periodically evaluate) a system of controls intended to limit potential financial exposure and to assure compliance with relevant regulatory requirements (the "Sponsored Access Release").[2] These recent initiatives are part of the SEC's ongoing review of the structure of the equity markets and follow two discreet SEC rule-making

[1] "Concept Release on Equity Market Structure," Rel. No. 34-61358 (Jan. 14, 2010), 75 F.R. 3594 (Jan. 21, 2010).

[2] "Risk Management Controls for Brokers or Dealers with Market Access," Rel. No. 34-61379 (Jan. 19, 2010), 75 F.R. 4007 (Jan. 26, 2010).

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initiatives from 2009 that the SEC currently is considering.[3]

This article discusses and analyzes the recent statements of the SEC and its staff on equity market structure, including the Concept Release. It also summarizes the SEC's related rule-making proposals, including the proposed sponsored access rule, as well as proposed rule amendments that would (i) subject dark pools to certain pre- and post-trade transparency obligations and (ii) ban flash orders by eliminating an exception from Regulation NMS that currently permits them.

SEC MARKET STRUCTURE REVIEW

The Concept Release conveys the SEC's concerns that current regulations intended to support and promote a competitive and an efficient NMS, including Regulation NMS, are not keeping pace with significant changes in trading technologies and trading practices. The SEC focuses on current structural elements of the equity markets that generally speaking could (i) give regulatory and competitive advantages to professional market participants at the expense of other participants; (ii) lead to greater market fragmentation; and (iii) detract from goals of public price transparency. In particular, the SEC highlights recent technological advances that are driving equity trading from the floors of stock exchanges to computer screens and matching engines whose highly automated functions are decreasing order transmission and execution times to milliseconds, or even microseconds.

Some background will be helpful to place the Concept Release in context. In light of new technologies and related trading strategies, long-term (and especially institutional) investors have been compelled to engage in a technological arms race in order to minimize the market impact and possible front-running of their trades. They have increasingly turned to their own trading algorithms or those of their market intermediaries, which divide large (or "parent") orders and send the constituent smaller (or "child") orders to a variety of market centers, both transparent and dark. This evolution of trading strategies, aided by changes in technology, has created a more complex and dispersed market ecosystem of high-frequency traders, dark pools, server co-location, and sponsored market access, all of which are designed to handle and capitalize on structural changes in the equity markets and the increased speed and volume capabilities of automated market centers.

In the SEC's view, these technologies have enabled professional market participants to adopt a new generation of trading strategies that is capable of taking advantage of pricing inefficiencies, liquidity incentives, and market momentum to an unprecedented degree. These factors raise questions for the SEC of the essential fairness of the equity markets and their linkages – a critically important focus of the Concept Release – as well as its ability to create a unified NMS. In particular, the Concept Release frames the SEC's specific focus on how long-term investors – those investors who provide risk capital as long-term owners of listed companies – currently fare in light of fully automated markets.

HIGH-FREQUENCY TRADING

The Concept Release discusses at length "high-frequency trading" ("HFT"), characterizing it as a "dominant component of the current market structure [that] is likely to affect nearly all aspects of [the market's] performance."[4] The SEC acknowledges that HFT is an undefined and relatively new term typically

[3] On September 18, 2009, the SEC proposed to eliminate an exception from the quoting requirements of Regulation NMS that currently permits "flash orders." *See* "Elimination of Flash Order Exception from Rule 602 of Regulation NMS," Rel. No. 34-60684 (Sept. 18, 2009), 74 F.R. 48632 (Sept. 23, 2009) (the "Flash Order Release"). On November 13, 2009, the SEC proposed rule amendments to Regulation NMS and Regulation ATS intended to promote pre- and post-trade transparency primarily for certain alternative trading systems ("ATS") known colloquially as "dark pools." *See* "Regulation of Non-Public Trading Interest," Rel. No. 34-60997 (Nov. 13, 2009), 74 F.R. 61208 (Nov. 23, 2010) (the "Dark Pool Release"). Each of these rule-making proposals is discussed below.

[4] Concept Release at 3606.

used to refer to professional traders who, through high-speed computer programs, submit on a daily basis large numbers of non-marketable orders, a large percentage of which ultimately are cancelled. Such traders may or may not be registered with the SEC as broker-dealers or investment advisers.

The function of HFT and its effect on long-term investors clearly implicate the central fairness issues raised and discussed by the Concept Release, although the SEC states that no particular bias should be read into any of the market issues it addressed. The Concept Release, however, does emphasize the SEC's longstanding position of giving priority to the interests of long-term investors over those of professional trading firms, when the two diverge.[5] To this point, the SEC questions whether long-term investors and brokers acting on behalf of retail investors possess the technological tools to compete adequately with HFT in their ability to find and route their orders to the best-priced market with minimal market impact.

The interaction of certain market forces has made HFT a dominant market force, which, by some estimates, accounts for 60% of the trading volume in NMS stocks.[6] Technology and modernizing rule changes – particularly decimalization and the "Order Handling Rules" (Rule 11Ac1-1 and Rule 11Ac1-4 under the Exchange Act) – have diminished bid-ask spreads, making it less profitable for professional trading firms to engage in traditional specialist or market-maker functions. HFT firms have entered the void left by the declining numbers of traditional specialists and market makers, as those firms have exited the marketplace.[7] In contrast to specialists and market makers, HFT firms do not have "affirmative obligations" to buy and/or sell in order to facilitate orderly markets, even when a market is moving against them. Nor do they have "negative obligations" to refrain from stepping in front of customer orders or otherwise taking advantage of their knowledge of customer order flow. Because HFT firms do not have the advantages that time and place privileges – *i.e.,* closer proximity to the time and place of execution – give market makers and specialists, they argue that they should have no "affirmative obligations," and because HFT firms typically trade solely in a proprietary capacity and thus have no customers, they also argue that they should have no "negative obligations."[8] The Concept Release requested comment on whether HFT firms should bear the market-quality duties of affirmative and negative obligations, or if some other form of regulation is needed.

HFT firms argue that their automated programs are more reliable providers of liquidity than specialists or market makers, and the Concept Release recognizes the potential efficient pricing benefits and narrow bid-ask spreads that may be derived from HFT. The SEC observes, however, that HFT firms frequently provide liquidity through a style of trading that involves a high volume of orders, a very large proportion of which they cancel (perhaps 90%). Most of these are non-marketable orders (*i.e.*, not at the national best bid or offer ("NBBO")) that are layered to detect and respond not just to displayed but also to latent orders. The Concept Release requests comment on whether HFT provides valuable liquidity to the market, echoing criticisms that HFT firms provide "low-quality" liquidity that contrasts with market makers' and specialists' affirmative obligations to buy and sell.[9]

Certain of the timing advantages recognized by HFT firms derive from their ability to enter into server co-location arrangements. Server co-location is a service provided by many market venues and third parties that host their matching engines, in which HFT firms rent "rack space" that enables them to place their trading computers' servers in close physical proximity to the matching engine processor.[10] HFT firms need co-location in order to ensure that they have the shortest possible delay in receiving information and the shortest latency (or delay) in placing and executing orders, given market centers' time-priority rules. In the Concept Release, the SEC requests comment on whether co-location (i) gives HFT firms unfair advantages in finding and capturing the best prices, (ii) enables them to provide liquidity more efficiently, and (iii) is the functional equivalent of the time and place privileges afforded specialists and market makers, such that imposing market quality obligations would be necessary.[11] Firms using co-location arrangements argue that it is fair and transparent, provided that there is

[5] *Id.* at 3603.

[6] Peter Chapman, *High-Frequency Traders Under Scrutiny*, Traders Magazine (Nov. 2009) ("*HFT Under Scrutiny*").

[7] *Id.*

[8] Will Acworth, *Making Markets: A Conversation with Five High-Frequency Trading Firms*, Futures Industry Magazine (Jan. 2010) at 21, 22, 24 ("*Making Markets*").

[9] *See HFT Under Scrutiny*.

[10] Peter Chapman, *SEC to Regulate Nasdaq's Co-Location*, Traders Magazine (Dec. 2009).

[11] Concept Release at 3610.

consistent pricing and access for every firm that wants it, and that it levels the field by reducing latency to the same minimum for every firm that needs it.[12] Although the SEC might regulate co-location arrangements, it appears unlikely that it will prohibit them. Commissioner Luis Aguilar recently stated that he is "not sure [that] banning co-location will solve anything because it [*i.e.*, server location] will just move to the next building or the building after that."[13]

The SEC also questions whether some HFT strategies are detrimental to the interests of long-term investors. The SEC focuses in particular on "order anticipation" and "momentum ignition" strategies. "Order anticipation" strategies, as the SEC points out, are nothing new: professional traders have always tried to determine when and if an investor was moving into a market in enough size to move prices so that the professional could trade in front of the large order to its advantage. HFT has brought a new generation of information technology to bear, including sophisticated order pattern recognition software and the use of "pinging" orders – rapid-fire non-marketable orders sent to a variety of market centers and canceled immediately if not taken – to try to detect the "footprints" left by a trading algorithm of a larger order, including a trade that has broken a large parent order into smaller child orders.[14] HFT firms argue that they need to use these techniques to move their orders out of the way of a market that is moving against them.[15] The SEC asks if HFT has made order-anticipation strategies a greater problem for long-term investors than previously has been the case.

The SEC also asks for comment on whether HFT can "ignite momentum" in a stock price by using the rapid submission and cancellation of orders to "spoof" other traders' algorithms into aggressive trading or to set off other traders' stop-loss orders. The SEC notes that such techniques could make stock prices more volatile: the SEC is searching for data that will help to resolve its concern that the equity markets' structure may encourage excessive volatility and thereby disproportionately reward short-term trading at the expense of long-term investing.

On April 14, 2010, the SEC took a first step toward acting on its concerns about HFT by proposing a new system that would allow monitoring of large traders' activity by requiring broker-dealers to record large traders' activity and report it to the SEC upon its request.[16] Using statutory authority obtained after the market declines of 1987 and 1989, the SEC proposed new Rule 13h-1 under the Exchange Act, which would require "large traders" to identify themselves as such to the SEC on new Form 13H and thereby obtain a Large Trader Identification Number ("LTID") from the SEC. Each large trader would then be required to disclose its LTID to each broker-dealer through which it trades and to identify all of the accounts at that broker-dealer through which it trades. A "large trader" would be defined as "any person that directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, in any aggregate amount equal to or greater than":

- Two million shares or shares with a fair market value of $20 million during a calendar day; or
- Twenty million shares or shares with a fair market value of $200 million during a calendar month.

The SEC stated that these thresholds derive from its intent to monitor activity of traders that effect transactions equal to or greater than approximately 0.01% of daily volume and market value of trading in NMS stocks. For large and complex financial organizations, the proposed definition is intended to focus on the parent company of the affiliates that exercise investment discretion: the parent would have to aggregate activity in counting towards the prescribed thresholds, and the rule would encourage the parent to identify itself as the large trader. Traders would not have to count towards the threshold certain categories of trades that the SEC deems less risky, such as purchasing shares in an offering from an issuer. Although this definition is intended to include HFT firms, it also is designed to capture a much broader segment of the trading public, including large mutual and hedge funds and proprietary trading desks.

The proposed rule also would impose recordkeeping and reporting requirements on broker-dealers that carry accounts for large traders, are themselves large traders, or exercise investment discretion over an account

[12] *See* Acworth, *Making Markets* at 24; *HFT Under Scrutiny*.

[13] *Co-Location Ban Won't Solve Anything*, Reuters (Apr. 5, 2010).

[14] James Ramage, *New Studies Assess High-Frequency Trading Impact*, Traders Magazine Online News (Dec. 9, 2009).

[15] Acworth, *Making Markets* at 24.

[16] "Large Trader Reporting System," Rel. No. 34-61908 (Apr. 14, 2010).

together with a large trader. Broker-dealers would have to maintain for three years (two years in an accessible place) certain specific information about each transaction effected by large traders; this information includes all of the information that broker-dealers are currently required to maintain under Rule 17a-25 under the Exchange Act, which establishes and governs the SEC's current transaction reporting system, the Electronic Blue Sheet ("EBS") system. In addition, broker-dealers would be required to record the LTID of the large trader that effected the trade and the time of the transaction. In this way, the new requirements would build on the existing EBS system and enable the SEC to create a time-specific audit trail for each large trader.

Broker-dealers also would be required to keep these records for "Unidentified Large Traders," *i.e.*, large traders that have not identified themselves that the broker-dealer knows or has reason to know is a large trader. Because this requirement is broad and vague, the SEC also proposed a safe harbor, under which a broker-dealer would be deemed not to know or have reason to know that a person is a large trader if the broker-dealer does not have actual knowledge that such person is a large trader and if the broker-dealer establishes and maintains policies and procedures reasonably designed to assure compliance with the requirements to identify large traders. The SEC explained that it would consider policies and procedures to be within the safe harbor if they are reasonably designed to detect and identify accounts as belonging to a large trader based on account name, tax identification number, or other readily available information, such as transfers between accounts.

Broker-dealers also would be required to report electronically to the SEC, upon its request, information about transactions in NMS securities effected directly or indirectly by or through accounts carried by the broker-dealer for large traders and Unidentified Large Traders, where such transactions are equal to or greater than 100 shares, or if the broker-dealer otherwise deems reporting appropriate. In proposing a reporting threshold so low, the SEC recognized that large traders often break up large "parent" orders into smaller "children" and that HFT firms often quote trade in lots of 100 shares or a few hundred shares. The SEC stated that any transaction information reported by a broker-dealer under the rule would be exempt from disclosure under the Freedom of Information Act, as would the information that large traders would disclose on Form 13H.

The SEC stated that the proposed rule is designed to facilitate its ability to assess the impact of large-trader activity on the securities markets (especially during times of peak activity and market stress), to reconstruct trading activity following periods of unusual market volatility, and to analyze significant market events for regulatory purposes. The SEC also would use the resulting data to detect and deter fraud, market manipulation, and other trading abuses. Because large traders are significant sources of liquidity and trading volume, their trading has a significant impact on the markets, which the SEC believes requires closer monitoring of large-trading activity. Accordingly, the SEC staff stated during the open meeting at which the rule was proposed that market volatility or significant price movements could trigger a request for data by the SEC.[17] It is an indication that the SEC intends to move cautiously on HFT that its first step in this area is an attempt to obtain more information about large traders' activity, and some HFT firms have praised it as such.[18]

DARK LIQUIDITY AND DARK POOLS

The SEC has adopted trading rules that seek to balance, on the one hand, the benefits of the public display of and public access to the best-priced limit orders with, on the other hand, the need to maintain trading anonymity of large, institutional orders to protect them from adverse market impacts. The SEC's current Order Handling Rules and "Order Protection Rule" (incorporated in Rule 611 of Regulation NMS) represent an attempt at striking an appropriate balance. The Order Handling Rules generally require market makers to display in the public quotation stream customer limit orders priced better than the NBBO. The Order Protection Rule, a key element of Regulation NMS, requires market centers to adopt policies and procedures reasonably designed to prevent, unless subject to limited exceptions, "trading through" better priced orders to trade at inferior prices at another market venue.

Not all trading, however, is subject to the SEC's price transparency rules, although most trading, except under limited circumstances, is subject to the Order Protection Rule. The Concept Release recognizes that so-called "dark liquidity" (*i.e.,* trading interest that is not included in the consolidated quotation data for NMS securities) has been historically an important component of the equity markets. Dark liquidity includes a range of forms, from manual trading by floor brokers on the

[17] Yin Wilczek, *SEC Proposes Large Trader Reporting Rule; Changes to Improve Access to Listed Options*, BNA Daily Report for Executives (Apr. 15, 2010) ("*Reporting Rule*").

[18] *See* Nina Mehta and Jesse Westbrook, *High-Speed Traders Face New Requirements from SEC*, Bloomberg.com (Apr. 8, 2010); *Reporting Rule*.

floors of stock exchanges, to internalization of order flow by over-the-counter market makers and block positioners, to more recent "dark pools" – a form of ATS registered with the SEC as broker-dealers. Although dark liquidity does serve beneficial market purposes under some circumstances, it also runs counter to one of the stated interests of an efficient NMS, namely to encourage "the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities."[19]

An ATS is not required to publicly display orders or provide public execution access for NMS stocks (essentially publicly listed stocks) unless its trading activity exceeds 5% of the average daily trading volume in four of the previous six months. Dark pools typically avoid publicly displaying and providing access to their best-priced orders because the volume of their trading falls below the current 5% threshold. According to the Concept Release, an important objective of dark pools is to offer institutional investors an alternative venue to stock exchanges or "publicly lit" electronic communication networks ("ECNs") for efficiently (and anonymously) trading large orders (often split into smaller orders).

Dark pools have become an important venue for large institutional order flow: the SEC reports the existence of approximately 32 dark pools, collectively attracting approximately 7.9% of the total share volume of NMS stocks, compared to five "publicly lit" ECNs (approximately 10.8% of total share volume), and registered stock exchanges (approximately 63.8% of total share volume).[20] While some are block-crossing networks that directly match large block orders, most primarily execute small orders (which may nonetheless be "children" of large "parent" orders). A number of dark pools (approximately 11) solicit trading by sending to selected traders indications of interest ("IOIs") in buying or selling particular stocks; IOIs typically take the form of trading data, and the SEC believes that context makes them "actionable," even though they typically do not include size or price information. The SEC is concerned that dark pools' use of actionable IOIs may divert order flow from publicly displayed quotes, decreasing the incentive to post them.

The SEC states that dark pools have the potential (i) to create market tiering, in which only sophisticated insiders gain access to important pricing information, and (ii) to erode price discovery, particularly as dark pools come to serve as more significant sources of liquidity for institutional order flow.

As a prelude to the Concept Release, the SEC proposed three rule changes, which take the form of amendments to Regulation NMS, Regulation ATS, and the joint industry plan for publicly disseminating consolidated trade data.[21] The proposals were primarily focused on the activities of dark pools and are intended in part to remedy the potential fragmentation, tiering, and erosion of price discovery that the SEC attributes to dark pools, through public disclosure of certain pre- and post-trade information generated by dark pools. At the same time, the SEC seeks to preserve the anonymity of block-trading activities by excepting from each of the proposed amendments certain block-trading and block-crossing activities (*i.e.,* orders with a value over $200,000 or more).

The proposed amendments may be summarized as follows:

- The SEC proposes treating actionable IOIs as the functional equivalent of "bids" or "offers" subject to public quotation reporting under Regulation NMS. This proposal would take the form of an amendment to the definitions of "bid" and "offer" under Regulation NMS, which currently does not include IOIs. The definition of "actionable IOI" would be contextual and would turn on whether the IOI explicitly or implicitly conveys (1) symbol, (2) side (buy or sell), (3) price better or equal to the NBBO, and (4) size of at least one round lot. The proposal would exclude from these requirements IOIs with a market value of over $200,000 that are communicated only to those who are reasonably believed to represent current contra-side trading interest of at least $200,000. The SEC's stated policy purpose is to give the public access to these IOIs and to improve quoted depth at best prices.

- The SEC proposes to lower the trading volume threshold that triggers public quotation display and access requirements from 5% to 0.25% over the specified period currently prescribed by Regulation ATS. This proposal also would exclude from the quotation display requirements "size discovery" orders of $200,000 or more in market value that are displayed only to those who are reasonably believed to represent current contra-side trading interest of at least $200,000. The SEC's stated policy purpose in

[19] Dark Pools Release at 61218, *citing* Section 11A(a)(1)(C)(iii) of the Exchange Act.

[20] Concept Release at 3599.

[21] *See* Dark Pools Release.

lowering the trading threshold of Regulation ATS is to give the public access to the majority of orders in NMS stocks communicated to market participants and thereby to prevent a two-tiered market. The SEC does not propose lowering the threshold to 0%, which would effectively require that any orders communicated by an ATS to more than one trader be made public, with the stated rationale being to "promote competition among trading centers"; the SEC's implicit goal is to give start-up ATSs an advantage.

- Lastly, the SEC proposes to require the consolidated trade data to include real-time disclosure of the identity of the ATS, including any dark pool, that executed the trade (such trades currently are identified only as "OTC"), unless the trade has a market value of $200,000 or more; the proposed rule amendment would not require disclosure of the identity of the traders. The SEC's stated policy purpose is to allow traders to better assess in real time on which trading venues executions are occurring and at what prices, which would theoretically enhance brokers' and traders' ability to find liquidity.

It is questionable whether these proposed amendments would fully achieve the SEC's goals. Dark pools attract institutional order flow primarily for the protection that they provide institutional orders against the adverse market impact that typically results when those orders are subject to public display. Real-time identification of the identity of dark-pool trades thus would likely expose many institutional orders to front-runners, as would dissemination of their orders to the market. According to one institution, "certain market intermediaries will see the particular ATS where a trade has been executed and use that information to detect a block order and trade ahead of it."[22] Therefore, should the advantages of anonymity be shut off to any large degree, institutional investors likely would find different strategies rather than publicly display their orders, leading to lower trading volume at dark pools.[23] The extent to which the proposal could lead to significant changes in the way that institutional order flow is processed perhaps would depend on the effectiveness of the proposed exceptions for block-crossing networks. It is not clear if the $200,000 exception for these networks would be sufficient to protect large orders from front-running, since institutions already feel compelled to break up large orders into smaller "child" orders rather than rely exclusively on block-crossing networks, especially for small- and mid-cap stocks.[24]

Under the SEC's proposals, dark pool customers would still retain the right to control whether or not to release their trading interest, and therefore many likely will not release it at all rather than have it publicly disseminated, *e.g.*, by sending their orders to pools that are completely dark, *i.e.*, that do not send or display orders to any traders.[25] In addition, dark pools would be able to avoid displaying orders in the public quotation stream if they did not send actionable IOIs to more than one person, so dark pools, to protect their customers' anonymity, in many cases likely will not display IOIs. Instead, large traders could adapt by using brokers to send "pinging" orders – immediate or cancel orders – to dark pools to find other undisplayed orders.[26] They also could use their brokers to send IOIs only to a select group of traders, since the rule amendments only apply to dark pools.[27]

The SEC's proposals also could have the unintended consequence of causing more market fragmentation. Dark pools that stay under the proposed 0.25% volume threshold could avoid the new display requirements, which could encourage a proliferation of new, smaller dark pools that could still offer IOIs with anonymity.[28] However, the SEC appears to have set the threshold so

[22] Jacob Bunge, *Institutions Warn on SEC Efforts to Reveal Dark Pool Trading*, Dow Jones Newswires (Feb. 25, 2010) ("*Institutions Warn*").

[23] Nina Mehta, *Dark Pools Under the Gun*, Traders Magazine (Dec. 2009); Nina Mehta, *SEC's Plan for Real-Time Dark Pool Attribution Spooks Industry*, Traders Magazine Online News (Dec. 11, 2009) ("*Spooks Traders*").

[24] Nina Mehta, *SEC Proposes Leveling Playing Field Between Dark and Lit Markets*, Traders Magazine Online News (Nov. 17, 2009) ("*Playing Field*"). Some brokers have argued that the threshold for this exception should be reduced, or that the exception should apply not just to block trades themselves but also to the "child" orders of broken-up block trade "parents." *Id.* One institution has proposed that the threshold be the lesser of (a) 1% of average daily trading volume, (b) 10,000 shares, or (c) $200,000. *See Institutions Warn.*

[25] *Id.*

[26] Peter Chapman, *Expect Widespread "Pinging in Dark Pools with SEC's IOI Proposal*, Traders Magazine Online News (Jan. 14, 2010); Peter Chapman and Nina Mehta, *SEC Proposal: Some Doubt IOI Rules Will Yield More Quoting*, Traders Magazine (Jan. 2010).

[27] *Playing Field.*

[28] *Spooks Traders*.

low that dark pools falling under it might not offer enough liquidity to attract much order flow.

In addition, the SEC's proposed definition of "actionable IOI" is deliberately ambiguous and leaves much to the judgment of each dark pool. It is not clear how dark pools will respond. One dark pool might feel compelled to be conservative and consider all IOIs to be actionable; another might deem none to be actionable, relying on a claim that disclosure of symbol and side does not imply price at the NBBO or size at the minimum round lot. The differing interpretations and effects of IOIs, therefore, could impede the uniform application of the rule, which could undermine the SEC's purpose of creating fair competition among market centers.

SPONSORED ACCESS

"Sponsored access" refers to an arrangement by which a broker-dealer allows a customer to use its market participant identifier to electronically access an exchange or ATS. In the Sponsored Access Release, the SEC describes two varieties of sponsored access: (i) "direct" access, which means that the customer's order flows through the broker-dealer's systems before going to the market; and (ii) "unfiltered" or "naked" access, which means that the customer's order goes directly to the market. Sponsored access provides advantages to customer order trading because it reduces latencies if the customer can directly access a trading venue, facilitates more rapid trading, and helps preserve the confidentiality of trading strategies. According to the SEC, sponsored access accounts for approximately 50% of average daily trading volume in the U.S. equities markets, and naked access accounts for approximately 38%.[29]

Many trading firms and hedge fund managers ("sponsored traders") believe that they need sponsored access in order to compete with brokers' proprietary trading desks in trading speed. Although mutual funds do not often use sponsored access arrangements, they do so sometimes, largely in order to avoid imparting information about their trading to broker-dealers' trading desks.[30] In contrast, some broker-dealers' proprietary traders claim that sponsored access gives unfair timing advantage to sponsored traders because these traders do not have to go through the brokers' risk controls, in contrast to the brokers' proprietary trades, which do.

The SEC believes that sponsored access, and particularly "naked access," creates a number of systemic risks. For example, sponsored access trades could result in breaches of capital or credit limits that could threaten the financial stability of the sponsoring broker and its counterparties. Sponsored traders could submit erroneous orders, perhaps in large numbers, as a result of computer malfunction (especially in algorithmic trading systems) or human error, which could lead to increased price volatility. Sponsored traders might submit malicious orders intended to disrupt the market system, or they might fail to comply with SEC or exchange trading rules or fail to detect illegal conduct by their personnel. The SEC cites examples of these sorts of problems, but admits that the identified risks of sponsored access have not yet created systemic problems to markets, and the proposed sponsored access rule, Rule 15c3-5 under the Exchange Act, is intended pro-actively to address potential risks to broker-dealers and the market.[31]

As proposed, Rule 15c3-5 would require broker-dealers with trading access to exchanges and ATSs to establish, maintain, document, and evaluate annually a system of risk management controls that is reasonably designed to:

- Systematically limit the broker-dealer's financial exposure from market access. The controls should prevent the entry of orders that exceed credit or capital thresholds or that appear to be erroneous. Each broker would be required to set appropriate credit limits for each customer (on an aggregate and on a sector- or security-specific basis) and appropriate capital thresholds for its own proprietary trading.

- Ensure regulatory compliance. The controls should prevent failures to comply with pre-trade regulatory requirements (*e.g.*, special order types, trading halts, Regulation SHO, and Regulation NMS), prevent entry of orders whose trading is restricted, restrict systems access to authorized persons, and assure surveillance personnel are given immediate post-trade reports. The procedures would have to be applied on an automated, pre-trade basis, which

[29] *See* Sponsored Access Release at 4007-4008.

[30] Letter from Ari Burstein, Senior Counsel, Investment Company Institute, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-03-10, (Mar. 29, 2010) at 2 ("*ICI Letter*").

[31] *See Id.* at 4008-4009.

would effectively prohibit "naked" or unfiltered access.[32]

These risk controls could not be outsourced or delegated to a third party, including the sponsored trader. Although certain compliance functions may permissibly be delegated, the SEC deliberately imposes the risk control obligations on the sponsoring broker-dealer itself to prevent regulatory arbitrage. SEC Chairwoman Schapiro described the rule as preventing brokers from "giving your car keys to a friend who doesn't have a license and letting him drive unaccompanied" and instead requiring that the broker "not only must remain in the car, but he must also see to it that the person driving observes the rules before the car is ever put into drive."[33]

However, some industry groups disagree. The Managed Funds Association ("MFA"), which represents hedge fund managers, points out that there can be subtle differences in the way broker-dealers' risk management technology implements sponsored access orders and orders from proprietary trading desks, which could favor the proprietary traders. The MFA proposes that sponsored traders be allowed to participate in the design and implementation of risk management technology along with brokers-dealers, which would still have exclusive control over the market access controls based on this technology.[34] In addition, both the MFA and Investment Company Institute ("ICI"), which represents mutual funds and their managers, are concerned that the requirement that broker-dealer surveillance personnel receive immediate post-trade execution reports could compromise the confidentiality of the fund information and enable broker-dealer trading personnel to ascertain fund trading methods. Both the MFA and the ICI propose that broker-dealers be required to maintain strict information walls and safeguards and to use trade reports only for regulatory purposes.[35]

The rule will likely be adopted, given the SEC's strong rhetoric and the fact that the SEC already has approved a similar Nasdaq rule. Given the imposition of controls, sponsored traders may be disadvantaged relative to the sponsoring firm's own proprietary trading desk. Thus, sponsored traders may consider a range of options. First, ATSs can offer direct access and membership to firms that are not broker-dealers, so there could be an increase in access and activity directly through ATSs. Second, the largest traders may contemplate registering as broker-dealers in order to obtain direct access to market venues instead of running trades through a sponsoring firm that is a member of a particular exchange.[36] Of course, this option is not without costs to the trading firm, which then must establish the necessary financial, operational, and compliance infrastructure to operate as a registered broker-dealer and obtain membership approvals from exchanges.

FLASH ORDERS

"Flash orders" are orders that a market center sends electronically to a select group of traders for "immediate" execution, *i.e.,* within a fraction of a second, before the market center displays them to the market. Flash orders are currently permitted under the SEC staff's interpretation of an exception in Rule 602 of Regulation NMS (the "Quote Rule") for orders that are immediately executed or canceled. The exception derived from a need to facilitate transactions that historically took place at the edge of the crowd on the exchange floor. Flash trading currently represents about 0.8% of listed equity volume. Two equity exchanges, the options exchanges and one equity ECN offer flash order capabilities to consenting customers.[37]

The SEC has a number of concerns regarding flash orders. First, the SEC is concerned that the use of flash orders creates two-tiered markets, in which those who receive flashed orders have priority access to the best-priced orders. Second, the SEC is concerned that the use of flash orders discourages the public display of trading interest, since those without priority access may believe that flash traders have an informational advantage. The SEC points out that flash orders could lead to locked markets (in which the bid and ask are at the same level) or even crossed markets (in which the bid is higher than the ask), since some market participants might not be aware of better priced flash orders. Lastly, the SEC is concerned that flash orders could be harmful to the

[32] *See Id.* at 4010.

[33] Statement at SEC Open Meeting – Market Access, Remarks of Mary Schapiro (Jan. 13, 2010).

[34] Letter from Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel, Managed Funds Association, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, SEC File No. S7-03-10, (Mar. 29, 2010) at 2 ("*MFA Letter*").

[35] *See ICI Letter* at 3; *MFA Letter* at 2-3.

[36] Nina Mehta, *Crackdown on Unsupervised Stock Trades May Spur More Brokerages*, Bloomberg.com (Jan. 14, 2010).

[37] Flash Order Release at 48633-48635; Nina Mehta, *The Past and Future of Flash Orders*, Traders Magazine (Dec. 2009) ("*Past and Future*").

submitter of the order, since the order might not be exposed to the full range of trading interest.[38]

The SEC, however, recognizes certain benefits of flash orders. It points out that the submitter of the flash order may get better execution on the market flashing the order than elsewhere. It notes that the flash order may be executed for lower fees or may result in a liquidity rebate from the market center flashing the order. The recipient of the flash order that supplies liquidity by taking the order may have lower transaction costs, which could get passed on in part to the order submitter. Market participants may be willing to provide liquidity through flash orders that they might not be willing to display publicly. And, market centers can use flash orders to maximize order flow and thus transaction fee revenue.[39]

Nonetheless, the SEC states that these benefits do not outweigh the costs of flash orders, especially the "penalty" imposed on the market participant who is displaying the NBBO but misses chances for order execution. The SEC describes the resulting disincentive to publicly display at the NBBO as a negative externality that detracts from the public good of price discovery.

Thus, the SEC proposed to eliminate from the Quote Rule the exception for orders that are executed or cancelled immediately. This amendment would prohibit flash orders by requiring exchanges that send out an order to some traders to publicly display the order. The SEC also would amend Regulation ATS, in effect to impose the same obligation to display any flashed order on those ATSs that are subject to public display requirements (*i.e.*, those having an average trading volume in excess of 5%).

Flash orders in stocks are likely to disappear because there is so much public and Congressional pressure to prohibit them, and the major exchanges are on record as opposing their use.[40] However, the options exchanges defend flash orders ("step-up orders" in their usage), which are widely used on these exchanges: because orders that are routed to other exchanges have to pay a "liquidity taker" fee, an exchange will first flash an order to its traders to see if one will "step up" and match the order.[41] Competing options market centers argue that step-up orders have hidden costs in the form of potentially poorer execution. Nonetheless, the different nature of the options markets might lead the SEC to consider if the public interest merits carving them out from any final rule.[42]

CONCLUSION

The Concept Release and the related rule proposals have not occurred in a vacuum. Rather, the SEC's actions and its ongoing review of equity market structure have been spurred by Congressional pressure and media reports, which in turn derive from public outcry about the recent financial crisis. Although equity market structure held up well during the crisis and did not contribute to the failures in the debt markets and many financial institutions, the nuances have been lost on many public and media critics, who are viewing the issues posed by HFT and related practices in isolation rather than in the context of a complex and interrelated market system. Nonetheless, these views are helping to shape the debate, and they likely will affect the SEC's ultimate actions. Market participants should prepare themselves for an unpredictable ride.■

[38] Flash Order Release at 48635-48637.

[39] *See* Flash Order Release at 48637-48638.

[40] Mehta, *Past and Future.*

[41] Mehta, *Past and Future*; Scott Patterson, *SEC's Flash Review Spurs Options Debate*, Wall St. J. (Dec. 4, 2009).

[42] For a further discussion of the proposed ban and other market structure issues, *see* Yim *et al.*, *The SEC's Proposed Ban on Flash Orders*, 42 Rev. Sec. & Comm. Reg. No. 20 (Nov. 18, 2009).

CLE QUESTIONS on Perlow & Peterson, *SEC Revisits Equity Market Structure in Concept Release and Rule Proposals* (May 5, 2010). Circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net. The cost is $60.00, which will be billed to your firm.

1. One of the SEC's concerns is high-frequency trading, although by some estimates it accounts for less than !0% of trading in NMS stocks. **True** **False**

2. The SEC has requested comment on whether HFT firms should bear market-quality duties to buy and/or sell in order to facilitate orderly markets, or if some other regulation is needed.
True **False**

3. In April, the SEC proposed a new system of monitoring large traders' activity that would require "large traders" to identify themselves as such on a new Commission form and would impose recordkeeping and reporting requirements on broker-dealers that carry accounts for large traders.
True **False**

4. The Commission has not proposed lowering the present trading volume threshold that triggers public quotation display and access requirements from the present 5%.
True **False**

5. On the subject of sponsored access, the Commission has proposed a new rule designed to limit a broker-dealer's financial exposure and ensure regulatory compliance with regard to sponsored access trading. **True** **False**

A F F I R M A T I O N

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