

FURTHER SEC ACTION ON MARKET STRUCTURE ISSUES

The Securities and Exchange Commission (the “SEC”) recently voted to:

- propose Rule 15c3-5 under the Securities Exchange Act of 1934 (the “Proposed Rule”), which would effectively prohibit a broker-dealer from providing customers with “unfiltered” or “naked” access to an exchange or an alternative trading system (“ATS”);¹ and
- publish a concept release (the “Concept Release”) requesting comment on a variety of market structure issues, including the efficacy of the current market structure, the impact of high-frequency trading on the markets, and “dark” liquidity concerns, such as market fragmentation.²

The Proposed Rule and the Concept Release represent the SEC’s most recent efforts in the area of market structure. Since the global financial crisis last fall, the SEC has also proposed amendments to certain existing rules related to market structure, including a ban on flash orders (which would prohibit a person who has not publicly displayed a quote from seeing orders before the public has had the opportunity to trade with those orders),³ and rule amendments intended to increase disclosure of trading interests by dark pools.⁴

Comments on the Proposed Rule are due on or before March 29, 2010. Comments on the Concept Release are due on or before April 21, 2010.

Overviews of the Proposed Rule and the Concept Release are set out below.

¹ Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 61379, 75 Fed. Reg. 4007 (Jan. 26, 2010), available at <http://www.sec.gov/rules/proposed/2010/34-61379.pdf>. See *SEC Proposes New Rule to Effectively Prohibit Unfiltered Access and Maintain Market Access Controls*, <http://www.sec.gov/news/press/2010/2010-7.htm> (Jan. 13, 2010).

² Concept Release on Equity Market Structure, Exchange Act Release No. 61358, 75 Fed. Reg. 3594 (Jan. 21, 2010), available at <http://www.sec.gov/rules/concept/2010/34-61358.pdf>. See *SEC Issues Concept Release Seeking Comment on Structure of Equity Markets*, <http://www.sec.gov/news/press/2010/2010-8.htm> (Jan. 13, 2010).

³ Elimination of Flash Order Exception From Rule 602 of Regulation NMS, Exchange Act Release No. 60684, 74 Fed. Reg. 48632 (Sept. 23, 2009). The comment period on the SEC’s flash trading ban proposal closed on November 23, 2009; no rule change has yet been adopted. Our client memo on this topic is available at the following address: http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3111/SEC_Proposes_To_Ban_Flash_Trading.pdf.

⁴ Regulation of Non-Public Trading Interest, Exchange Act Release No. 60997, 74 Fed. Reg. 61208 (Nov. 23, 2009). The comment period on the SEC’s dark pools disclosure proposal closes on February 2, 2010. Our client memo on this topic is available at the following address: http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3154/SEC%20Proposes%20Rules%20to%20Increase%20Disclosure.pdf.

Proposed Rule 15c3-5

In the release proposing Rule 15c3-5 (the “Proposing Release”), the SEC states that customers of broker-dealers, particularly sophisticated institutional customers, have begun using technology to place orders “with little or no substantive intermediation by their broker-dealers,”⁵ giving rise to “direct market access” or “sponsored market access.” This type of market access generally involves an institutional or individual customer who uses the broker-dealer’s market participant identifier (“MPID”) or other mechanism to access an exchange or ATS electronically. “Direct access” typically refers to a customer securities order that flows through a broker-dealer’s systems before entering the markets. “Sponsored access” typically involves a customer securities order that flows directly to the markets without first passing through a broker-dealer’s systems. Irrespective of how such orders flow to the markets, the broker-dealer is responsible for all trading that occurs using its MPID.

The SEC is particularly concerned about sponsored access arrangements in which a broker-dealer does not employ any pre-trade risk management controls, referred to as “unfiltered,” or “naked,” access. The concern is that if a customer has such access, the broker-dealer might be unaware of the trading activity being effected under its market identifier and therefore would be unable to control such activity.⁶ This lack of oversight could raise risks relating to potential breaches of credit or capital limits, the submission of erroneous orders, the failure to comply with SEC or exchange trading rules, or the failure to detect other unlawful conduct. The SEC believes that risk management controls and supervisory procedures that are not applied on a pre-trade basis or that are not under the broker-dealer’s exclusive control are inadequate to address risks associated with market access that could pose a significant danger to the U.S. national market system.

Proposed Rule 15c3-5 would require a broker-dealer with market access, or that provides another party with access to an exchange or ATS through use of the broker-dealer’s MPID or through other means, to establish, document, and maintain a system of risk management controls and supervisory procedures designed to manage the financial, regulatory, and other risks associated with providing such access. The Proposed Rule would apply to all securities trading on an exchange or ATS, including equities, options, exchange-traded funds, and debt securities.

The Proposed Rule outlines the types of activities and practices that implementation of financial and regulatory risk management controls and supervisory procedures should prevent from occurring. The financial risk management controls and supervisory procedures that the Proposed Rule would require are intended to, and should be designed to, limit a broker-dealer’s financial responsibility relating to granting market access. Proposed Rule 15c3-5(c)(1) would require such controls and procedures to be reasonably designed to (i) prevent the entry of orders that exceed appropriate credit or capital limits in the aggregate for each customer and the broker-dealer, and (ii) prevent the entry of erroneous orders by rejecting orders that exceed specified price or size parameters, either on an order-by-order basis or over a short period of time, or that

⁵ Proposing Release at 4008.

⁶ *Id.*

indicate duplicative orders. If appropriate, credit and capital limits could be established by sector, security, or otherwise.

Given the speed of electronic markets, the SEC believes that the financial risk management controls and supervisory procedures should be “systematized and automated” and applied on a pre-trade basis. Such controls should block orders that do not comply with the controls from being routed to a securities market. Controls should be reasonably designed to detect malfunctions of automated systems that could lead to erroneous orders, as well as to block the routing of erroneous orders entered manually. Moreover, the broker-dealer would be required to set a credit threshold for each customer with market access, as well as set appropriate capital thresholds for the broker-dealer’s proprietary trading, and to institute controls and procedures to help ensure that the credit or capital thresholds are not exceeded. Broker-dealers should also consider “early warning” thresholds that would alert the broker-dealer if thresholds were being approached so that trading behavior could be adjusted accordingly.⁷

Proposed Rule 15c3-5(c)(2) would require a broker-dealer to implement and maintain regulatory risk management controls and supervisory procedures reasonably designed to (i) prevent the entry of orders unless applicable regulatory requirements have been met on a pre-order basis; (ii) prevent the entry of orders for securities for a broker-dealer, customer, or other person who is restricted from trading in such securities; (iii) grant access to systems that provide market access only to those persons and accounts authorized by the broker-dealer; and (iv) provide surveillance personnel with immediate post-trade execution reports resulting from market access. Because certain risk management controls and supervisory procedures would be applied on a pre-trade basis (and, in some instances, on an automated basis), the Proposed Rule would effectively prohibit “unfiltered,” or “naked,” access.

Among other things, regulatory risk management controls would need to be reasonably designed to prevent orders from being sent to securities markets unless the order complied with, for example, exchange trading rules relating to special order types, trading halts, odd-lot orders, SEC rules under Regulations SHO and NMS, and margin rules. The controls also would need to be designed to prevent the entry of orders for securities restricted from trading. Supervisory tools would need to allow monitoring in real time.⁸

To limit access to systems that provide market access, a broker-dealer would need to review and approve all persons at the broker-dealer or its customer with such access. The systems that provide such access would need to be physically secured and access would be subject to electronic security, such as passwords.

⁷ Proposing Release at 4013 - 4014.

⁸ *Id.* at 4014.

Post-trade surveillance would include review of execution reports relating to market access. These reports would allow identification of the customer associated with each report to assist in detecting potential regulatory violations, and would provide data regarding financial exposure faced by the broker-dealer at a given time.

Proposed Rule 15c3-5(a)(1) would define “market access” as “access to trading in securities on an exchange or alternative trading system, respectively.” The SEC notes that this definition is intentionally broad so that it includes not only direct or sponsored access, but also proprietary trading and agency trading.⁹ This broad definition is intended to require a broker-dealer with direct access to an exchange or ATS to “establish effective risk management controls to protect against breaches of credit or capital limits, erroneous trades, violations of SEC or exchange trading rules, and the like.”¹⁰

“Regulatory requirements” would be defined as “all federal securities laws, rules and regulations, and rules of self-regulatory organizations, that are applicable in connection with market access” under proposed Rule 15c3-5(a)(2). This definition is intended to capture all existing regulatory requirements related to a broker-dealer’s access to trading on an exchange or ATS.

A broker-dealer would not be permitted to outsource risk management obligations under proposed Rule 15c3-5(d). The SEC believes that the risks associated with delegating these functions to a third party, such as a customer, are too great, and takes the position that a broker-dealer must be able to monitor the operation of its risk management tools in real time.¹¹

Moreover, proposed Rule 15c3-5(e) would require a broker-dealer providing market access to establish, document, and maintain a system to review, at least annually, the effectiveness of the controls and procedures mandated by proposed Rule 15c3-5(c) and to address any issues that might arise from the review. The chief executive officer, or an equivalent officer, of the broker-dealer would be required to certify annually that the broker-dealer’s risk management controls and supervisory procedures complied with proposed Rule 15c3-5 and that the regular (at least annual) review had been conducted.

A broker-dealer would be required to preserve for three years a copy of its supervisory procedures and a written description of its risk management controls as part of its books and records per Rule 17a-4(e)(7) and Rule 17a-4(b) under the Exchange Act.

The SEC recently approved a Nasdaq rule that requires broker-dealers that provide direct market access or sponsored access to employ many of the types of risk and regulatory systems set out in the Proposed Rule. The SEC, however, believes that a stricter rule is necessary to prohibit “unfiltered,” or “naked,” access.

⁹ Proposing Release at 4012.

¹⁰ *Id.* at 4012.

¹¹ *Id.* at 4014.

Concept Release

The SEC states that the Concept Release is intended to be a broad review of the U.S. equity market structure in light of the evolution of the securities markets from floor-based trading to highly automated, electronic trading. The SEC focuses on whether the current market structure serves the interests of long-term equity investors whose investments are made directly in equities, through retirement plans, or through other institutional investors that invest on behalf of a number of individuals.

The Concept Release includes an overview of the current market structure¹² in which the SEC identifies four major types of trading centers:

- (i) registered exchanges, which the SEC states all have highly automated trading systems that offer high-speed, low-latency order responses and executions; offer direct data fees to customers; and offer a wide range of order types for trading on their automated systems;
- (ii) electronics communications networks, or “ECNs,”¹³ which typically provide their best-priced orders for inclusion in consolidated quotation data and offer services analogous to those offered by registered exchanges;
- (iii) “dark pools,” which are ATSs that do not provide their best-priced orders for inclusion in consolidated quotation data; and
- (iv) non-ATS broker-dealers that internally execute trades, on either a principal or agency basis. Such internalized executions typically are not included in the consolidated quotation data and are referred to as “broker-dealer internalization.”¹⁴

The SEC’s discussion notes that consolidated market data is collected and distributed under a number of Exchange Act rules and joint-industry plans. The SEC also addressed Rule 611 of Regulation NMS under the Exchange Act, which provides trade-through protection. A “trade-through” is an execution of a trade at a price inferior to a protected quotation in an NMS stock.

¹² To illustrate its point that market structure has changed dramatically over the past few years, the SEC provides statistics showing a substantial decrease in average execution speed for small, immediately executable orders on the New York Stock Exchange (“NYSE”); a significant increase in the average daily trading volume of NYSE-listed stocks; and a significant decrease in the average trade size of NYSE-listed stocks, among other things. *See* 75 Fed. Reg. at 3595.

¹³ The SEC notes that (i) five ECNs that actively trade NMS stocks execute approximately 10.8% of share volume, and (ii) two ECNs execute almost all ECN volume. 75 Fed. Reg. at 3599. Rule 600(47) of Regulation NMS under the Exchange Act defines an “NMS stock” as “any NMS security other than an option.” Rule 600(46) of Regulation NMS defines “NMS security” as “any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options.”

¹⁴ Concept Release at 3599.

The SEC notes that Rule 611 helps promote linkages by encouraging trading centers to route marketable orders to a trading center that is displaying the best price. Finally, the Concept Release discusses broker-dealer routing services. Broker-dealers offer smart order routing services to access liquidity and provide algorithms that allow institutional investors to divide a large order into a number of smaller orders. In executing a customer order, a broker-dealer must obtain the best terms reasonably available.¹⁵

The Concept Release invites comment on all matters related to market structure but seeks comment on the following three specific areas: (i) market structure performance and how to measure it; (ii) high-frequency trading (and related concerns about co-location services, trading strategies, and systemic risk); and (iii) undisplayed, or dark, liquidity.

Market Structure Performance

The SEC requests comment on how well or poorly the current market structure is performing its vital economic functions, which are identified as “promot[ing] capital raising and capital allocation by establishing prices for securities and by enabling investors to enter and exit their position in securities when they wish to do so.”¹⁶ The SEC focuses particularly on whether the current market structure is fair to long-term investors¹⁷ or favors professional traders who may have a short time horizon with respect to investments and may be the only ones who can trade effectively in today’s complex market.

To assist in assessing the performance of the current market structure, the SEC seeks comment on what metrics might be useful in assessing the performance of the current market structure. Metrics often used include measures of spreads, such as quoted spreads, effective spreads (which reflect prices received that are worse than, equal to, or better than quoted spreads), and realized spreads (which reflect the impact of investors on subsequent price movements in a stock). Execution speed is another metric typically used in evaluating market speed. The SEC notes, however, that spreads and execution speed may not accurately reflect execution quality. According to the SEC, other factors, such as short-term volatility, could harm long-term investors through short-term price movements that could be many times the spread. Long-term investors may not have the capacity to react to short-term price movements as quickly as high-frequency traders. The SEC seeks comment on whether metrics that focus on the execution of smaller orders are useful and, if so, which metrics are the most useful.

The Concept Release also discusses transaction costs paid by institutional investors. In particular, the SEC seeks comment on whether published analyses of institutional investor transaction costs accurately reflect costs and whether other analyses should be considered.

¹⁵ Concept Release at 3600 - 3603.

¹⁶ *Id.* at 3603 - 3606.

¹⁷ The SEC also seeks comment on what distinguishes a long-term investor from a short-term professional trader.

The SEC also asks whether metrics that are useful for assessing market structure performance for long-term investors have been worsening or improving in recent years and whether any current regulations may be harming market quality.

The Concept Release notes that metrics of market performance may be affected by broad economic forces, such as the recent global financial crisis, that are not the product of market structure, and it asks how the effect of such forces should be adjusted for in assessing the performance of market structure over various timeframes.

The SEC seeks comment on whether the current market structure is fair to long-term investors generally. The primary focus of the SEC's inquiry into this fairness question is whether long-term investors who may not be able to access the securities markets through the fastest systems are disadvantaged by that lack of high-speed access. A corollary to that inquiry is whether long-term investors may in fact have fast access to the markets through the broker-dealers that execute trades on behalf of such investors.

The Concept Release inquires into the sufficiency of Rules 605 and 606 of Regulation NMS under the Exchange Act. Rule 605 requires market centers to make public monthly electronic reports that include the volume of orders executed, speed of execution, spreads, and price improvement, and the SEC asks whether the reporting of speed of order execution needs to be "more finely tuned," such as by reporting speeds to the hundredths or thousandths of a second, rather than to tenths of a second.

Rule 606 requires a broker-dealer to make public quarterly reports on order routing that include statistics about order types and the trading venues to which orders were routed. The Concept Release seeks comment on whether Rules 605 and 606 should be updated to address the interests of institutional investors in efficiently executing large orders and, if so, what metrics would be useful for such investors. For example, the SEC asks whether information on intermarket sweep orders should be reported separately from information on regular orders.

High-Frequency Trading

The SEC devotes a significant portion of the Concept Release to issues relating to high-frequency trading ("HFT") and is interested in receiving comments on whether HFT and, in particular, certain HFT strategies, are harmful to the performance of market structure.¹⁸ The Concept Release notes that the term is not defined, but that HFT generally entails professional traders engaging in proprietary trading that generates a large number of trades each day. In addition, the SEC states that HFT generally is characterized by (i) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders; (ii) the use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (iii) very short timeframes for establishing and

¹⁸ Concept Release at 3602 - 3612.

liquidating positions; (iv) the submission of numerous orders that are canceled shortly after submission; and (v) ending the trading day in as close to a flat position as possible. Equity market trading volume attributable to HFT is estimated to be at least 50% of total volume.

Passive Market Making and Liquidity Rebates

The SEC notes that in many trading centers, certain strategies employed by proprietary trading firms, including those acting as passive market makers, have largely replaced the role of specialists and market makers. Comment is sought on whether proprietary firms, as in the case of specialists, should be subject to affirmative or negative trading obligations.¹⁹

Passive market makers submit non-marketable resting orders and earn profits by buying at the bid, selling at the offer and earning liquidity rebates that many trading centers offer. The SEC seeks comment on whether passive market makers provide valuable liquidity and whether market quality has improved as such market makers have replaced traditional liquidity providers.

The SEC also seeks comment on HFT geared toward earning liquidity rebates and on any benefits or drawbacks to such trading, as well as on whether the rebates are unfair to long-term investors because they are paid primarily to proprietary trading firms that engage in passive market-making strategies.

Arbitrage and Directional Trading Strategies

The SEC seeks comment identifying arbitrage strategies and whether they help or harm investors. It also asks whether strategies designed to exploit structural market vulnerabilities affect market quality.

The SEC also seeks comment on directional strategies, including (i) an order-anticipation strategy, in which a proprietary trading firm attempts to ascertain the existence of large buyers or sellers in the market in the hopes of trading ahead of a large order to profit by capturing the price movement likely to be caused by such an order, or (ii) a momentum-ignition strategy, which involves initiating orders or effecting trades with the intent of “spoofing” the algorithms of other traders into moving in a particular direction more aggressively, and capturing the profit that may result from causing prices to move in that direction. The SEC asks whether these directional strategies are harmful to market structure and to what extent proprietary trading firms engage in such strategies.

¹⁹ The SEC suggests that, as in the case of exchange specialists and OTC market makers, passive market makers enjoy special time and place privileges in exchange trading, but are not subject to affirmative and negative trading obligations. Affirmative obligations could include a requirement to display consistent, high-quality, two-sided quotations. Negative obligations might include a restriction on “reaching across the market” to execute against displayed quotations and thereby cause price moves.

Co-Location Services

The Concept Release contains an extensive discussion about co-location services, where a trading center or third party rents space to market participants to place their computer servers near the trading center's matching engine to minimize communication latencies between the matching engines in order to achieve faster trading speeds. The SEC seeks comment with respect to whether these services give an unfair advantage to entities that can afford to pay to use them.

The SEC takes the position that co-location services are subject to the Exchange Act. An exchange that wishes to offer co-location services must file and receive SEC approval of proposed rule changes before offering such services to customers. Moreover, given the requirements in Exchange Act Section 6(b) applicable to exchange rules, the terms of co-location services may not be unfairly discriminatory and fees must be equitably allocated and reasonable.

The SEC asks whether co-location services benefit or harm long-term investors and market quality, whether broker-dealers can obtain and use co-location services on behalf of their customers, whether long-term investors are harmed by not being able to use the services directly, whether fees for such services create a barrier for smaller firms, and whether third-party data facilities should be considered facilities of a trading center and subject to regulatory oversight. The SEC also asks whether trading centers should be prohibited from offering such services if they create unfair access to trading and, if such services continue to be offered, whether trading centers offering the services should be subject to requirements intended to help ensure that users are treated in a manner that is not unfairly discriminatory. Finally, the SEC asks whether co-location provides users with advantages akin to those enjoyed by specialists such that users of these services should be subject to affirmative or negative trading obligations.

Individual Direct Data Feeds

The Concept Release also seeks comment on trading center data feeds. Many exchanges and ECNs provide investors, for a fee, direct, individual data feeds that include that particular market's best-priced quotations and trades, as well as certain other information, such as inferior-priced orders included in their depth-of-book to minimize potential latencies that might arise if such data is first sent to a vendor to be consolidated with data from other markets, and then forwarded in consolidated form to the investor. The SEC asks whether latency associated with delivery of consolidated data can be improved, *i.e.*, reduced as compared to the speed at which data from trading center data feeds is delivered. The SEC also seeks comment on whether any latency associated with the delivery of consolidated data is unfair to investors that must rely on consolidated market data feeds rather than on individual trading center data feeds and, if so, whether such unfairness should be addressed by requiring delay of trading center data for a period sufficient to ensure that consolidated data reaches investors first. The SEC also asks whether consolidated trade data should include reports of odd-lot transactions, and seeks comment on why a substantial volume of trading is attributable to such transactions.

High-Frequency Trading as a Systemic Risk

The SEC asks generally whether HFT poses significant risks to the integrity of the current equity market structure, including whether similar or connected strategies used simultaneously by a number of proprietary trading firms could lead to the generation of significant losses, causing both a number of proprietary trading firms to become financially distressed and large fluctuations in market prices. Given that proprietary trading firms often obtain financing for their trading activities from broker-dealers, the SEC is concerned that significant losses at many proprietary trading firms simultaneously could lead to financial distress at such broker-dealers.

The SEC notes, however, that the equity markets functioned well during the financial crisis in the autumn of 2008.

Undisplayed Liquidity

The Concept Release seeks comment on a number of issues related to undisplayed, or “dark,” liquidity, which the SEC generally views as “trading interest that is available for execution at a trading center, but is not included in the consolidated quotation data that is widely disseminated to the public.”²⁰ According to the SEC, undisplayed liquidity has largely migrated from the manual trading floors of exchanges to new venues, particularly ATSS, but also to broker-dealers that internalize orders.

The SEC seeks comment on three broad issues related to undisplayed liquidity. First, the SEC asks whether undisplayed liquidity impacts order execution quality. The SEC notes a strong Exchange Act policy in favor of price transparency and displayed markets and asks whether dark pools and OTC market makers offer substantial order execution quality advantages to long-term investors, particularly individuals. A related issue is whether access fees that OTC market makers charge are comparable to those that the public markets charge. The SEC also asks whether dark pools improve execution quality for the large orders of institutional investors and whether the execution of orders by such pools with reference to displayed prices in public markets subjects institutional investors to improper behavior, such as trading by a third party using a small order to change the national best bid and offer (the “NBBO”) for a very short period and submitting orders to dark pools for execution at the new NBBO. The SEC requests comment on whether institutional investors are able to trade more efficiently by using undisplayed liquidity at dark pools and broker-dealers than by using exchanges and ECNs.

Second, the SEC seeks comment on whether the level of undisplayed liquidity has detracted from public price discovery and execution quality and, if the current level of undisplayed liquidity has not detracted from public price discovery, whether there is a level at which it will do so. The SEC is also trying to determine whether long-term investors are making greater use of undisplayed liquidity.

²⁰ Concept Release at 3612 - 3614.

The SEC invites comment on whether it should consider a “trade-at” rule that would prohibit a trading center from executing a trade at the NBBO unless that trading center was displaying that price at the time of the incoming contra-side order. In effect, such a rule would impose a limited system-wide time-and-price priority requirement. The SEC also asks whether it should consider expanding trade-through protection to displayed “depth-of-book” quotations, rather than only “top-of-book” quotations.

Third, the SEC seeks comment on fair access and Regulation ATS. Regulation ATS currently does not require a dark pool to provide fair access to market participants unless it reaches a 5% trading volume threshold in a stock. The SEC asks whether the access threshold should be lower and, if so, what that threshold should be and whether investors have sufficient information about dark pools to determine whether to seek access. Finally, comment is requested as to whether there are other ways in which Regulation ATS should be amended to reflect the role of ATSs in the current market structure.

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