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## SEC Publishes Concept Release on Market Structure, Proposes Risk Management Rules for Sponsored Access

On January 14, 2010, the Securities and Exchange Commission (“SEC”) voted to issue 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”).<sup>1</sup> The Concept Release revisited issues that the SEC raised and addressed nearly five years ago in a comprehensive set of market, trading and reporting rules codified in Regulation NMS. Shortly after publishing the Concept Release, the SEC also published a release proposing a new risk management rule requiring 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 ensure compliance with relevant regulatory requirements (the “Sponsored Access Release”).<sup>2</sup> These recent market-structure initiatives form part of the SEC’s ongoing review of the equity markets and follow two discrete SEC rule-making initiatives from 2009 currently under consideration.<sup>3</sup>

### SEC Market Structure Review

The Concept Release conveyed the SEC’s concerns that current regulations intended to support and promote a competitive and an efficient national market system (an “NMS”) are not keeping pace with significant changes in trading technologies and trading practices. The SEC focused 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 highlighted recent technological advances that are driving equity trading from trading on 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.

In light of new technologies and related trading strategies, long-term (and especially institutional) investors have been compelled to engage in a technological arms

<sup>1</sup> “Concept Release on Equity Market Structure,” Securities Exchange Act Release No. 61358 (Jan. 14, 2010), 75 F.R. 3594 (Jan. 21, 2010).

<sup>2</sup> “Risk Management Controls for Brokers or Dealers with Market Access,” Securities Exchange Act Release No. 61379 (Jan. 19, 2010), 75 F.R. 4007 (Jan. 26, 2010).

<sup>3</sup> 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,” Securities Exchange Act Release No. 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 ATSS known colloquially as “dark pools.” See “Regulation of Non-Public Trading Interest,” Securities Exchange Act Release No. 60997 (Nov. 13, 2009), 74 F.R. 61208 (Nov. 23, 2010) (the “Dark Pool Release”).

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. These market forces, aided by changes in technology, have 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 are capable of taking advantage of pricing inefficiencies, liquidity incentives and market momentum to an unprecedented degree, which raise questions for the SEC of the essential fairness of the equity markets and their linkages – a critically important focus of the Concept Release – into a unified NMS. In particular, the Concept Release framed 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 discussed at length “high frequency trading” (“HFT”), characterizing it as a “dominant component of the current market structure [which] is likely to affect nearly all aspects of [the market’s] performance.”<sup>4</sup> The SEC acknowledged that HFT is an undefined and relatively new term typically used to refer to professional traders that, through high-speed computer programs, submit on a daily basis large numbers of non-marketable orders, a large percentage of which ultimately are cancelled.

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.<sup>5</sup> Technology and modernizing rule changes – particularly decimalization and the “Order Handling Rules” under the Securities Exchange Act of 1934 (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.<sup>6</sup> 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 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.”<sup>7</sup> The Concept Release requested comment on whether HFT firms should bear the market-quality duties of affirmative and negative obligations, or if some other forms of regulation are needed.

HFT firms argue that their automated programs are more reliable providers of liquidity than specialists or market makers, and the Concept Release recognized the potential efficient pricing benefits and narrow bid-ask spreads that may be derived from HFT. The SEC observed, 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 are cancelled (perhaps 90%), and most of which are non-marketable orders (*i.e.*, not at the national best bid or offer) that are layered to detect and respond to not just displayed but also latent orders. The Concept Release requested comment on whether HFT provides

<sup>4</sup> Concept Release at 3606.

<sup>5</sup> Peter Chapman, *High-Frequency Traders Under Scrutiny*, *Traders Magazine* (Nov. 2009) (“HFT Under Scrutiny”).

<sup>6</sup> *Id.*

<sup>7</sup> Will Acworth, *Making Markets: A Conversation with Five High-Frequency Trading Firms*, *Futures Industry Magazine* (Jan. 2010) at 21, 22, 24 (“*Making Markets*”).

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.<sup>8</sup>

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.<sup>9</sup> HFT firms need co-location in order to ensure that they have the shortest possible delay in receiving information and the shortest latency in placing and executing orders, given market centers’ time priority rules. In the Concept Release, the SEC requested comment on whether co-location (i) gives HFT firms unfair advantages in finding and capturing the best prices, (ii) enables HFT firms 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.<sup>10</sup> Firms using co-location arrangements argue that it is fair and transparent, provided that there is 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.<sup>11</sup>

The SEC also questioned whether some HFT strategies are expressly detrimental to the interests of long-term investors. The SEC focused in particular on “order anticipation” and “momentum ignition” strategies. “Order anticipation” strategies, as the SEC pointed 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.<sup>12</sup> 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.<sup>13</sup> The SEC asked if HFT has made order-anticipation strategies a greater problem for long-term investors than has previously been the case.

The SEC also asked for comment on whether HFT can “ignite momentum” in a stock price by using the rapid submission and cancellation of orders to “spoofer” other traders’ algorithms into aggressive trading or to set off other traders’ stop-loss orders. The SEC noted that such techniques could make stock prices more volatile: the SEC is searching for data that will help it 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.

## Sponsored Access

“Sponsored access” refers to an arrangement under 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 described 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, direct access accounts for approximately 50% of average daily trading volume in the U.S. equities markets, and naked access accounts for approximately 38%.<sup>14</sup>

<sup>8</sup> See *HFT Under Scrutiny*.

<sup>9</sup> Peter Chapman, *SEC to Regulate Nasdaq’s Co-Location*, *Traders Magazine* (Dec. 2009).

<sup>10</sup> Concept Release at 3610.

<sup>11</sup> See Acworth, *Making Markets at 24; HFT Under Scrutiny*.

<sup>12</sup> James Ramage, *New Studies Assess High-Frequency Trading Impact*, *Traders Magazine Online News* (Dec. 9, 2009).

<sup>13</sup> See Acworth, *Making Markets at 24*.

<sup>14</sup> See Sponsored Access Release at 4007-4008.

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. 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 proprietary traders.

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 is able to cite examples of these sorts of problems but admitted that 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 proactively to address potential risks to broker-dealers and the market.<sup>15</sup>

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 are 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.

<sup>15</sup> See Sponsored Access Release at 4008-4009.

- 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 must be applied on an automated, pre-trade basis, which would effectively prohibit “naked” or unfiltered access.<sup>16</sup>

These risk controls could not be outsourced or delegated to a third party, including the sponsored trader. Although certain compliance functions may be permissibly delegated, the SEC deliberately imposed the risk control obligations on the sponsoring broker-dealer itself to prevent regulatory arbitrage. SEC Chairman 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.”<sup>17</sup> The rule will likely be adopted, given the SEC’s strong rhetoric and that the SEC has already approved a similar Nasdaq rule.

## Conclusion

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 in which the nuances in a complex and interrelated market system have been lost. 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 a rough and unpredictable ride.

<sup>16</sup> See Sponsored Access Release at 4010.

<sup>17</sup> Statement at SEC Open Meeting – Market Access, Remarks of Mary Schapiro, Chairman, U.S. Securities and Exchange Commission (Jan. 13, 2010).

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