Compliance Corner

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The SEC Looks To Tighten Its Regulatory "Reins" with Market Structure Reform—But Will It Adversely Impact Asset Managers?

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Regulators and policy makers are considering a number of market structure reforms that, if implemented as proposed, could adversely impact asset managers' businesses by impeding access to the wide variety of trading centers currently available, limiting flexibility in choosing research providers and increasing trading costs, resulting in reduced investment returns for clients. As the regulatory and political agenda continues to be focused on the integrity of financial market participants, the industry has witnessed a number of significant proposed or adopted market structure related regulatory initiatives by the SEC and a recent crackdown by regulators aimed at high frequency traders. Though not the direct target, these market structure initiatives will have an effect on the asset management industry, particularly with respect to portfolio managers' access to research providers and traders' ability to efficiently implement a variety of trading strategies that rely on high frequency trading, low costs, and anonymity.

The crackdown on high frequency traders may have many far reaching and unintended effects. Over the past year, the SEC has proposed rules that would require greater pre-trade risk management controls in sponsored access arrangements that, effectively, would ban "naked" or "unfiltered" market access widely used within the industry and issued a concept release on equity market structure that puts high frequency trading under the regulatory microscope. Now, on the heels of a recent "quote stuffing" enforcement action by the Financial Industry Regulatory Authority ("FINRA"), participants in the asset management industry await the SEC report on the May 6 "flash crash" and whether further regulations will limit not only their current access to liquidity and market venues, but also the types of trading strategies and investment methodologies they may use to invest on behalf of their clients.

I. HIGH FREQUENCY TRADERS - THE BEGINNING OF THE ASSUALT ON "QUOTE STUFFING"

Almost immediately after the "flash crash," the SEC appointed Gregg E. Berman to lead the 20 member team looking into whether a practice called "quote stuffing" is distorting stock prices and what role, if any, it played on May 6 when the Dow Jones Industrial Average collapsed almost 1000 points in minutes. The term "quote stuffing" refers to the practice of placing an unusually large number of orders to buy or sell stocks within a fraction of a second, only to cancel those orders almost immediately. This practice may distort share prices and trading volume, but there are those within the asset management industry that argue this practice can also provide valuable information regarding liquidity and depth of the market in a market structure that is fractured and not nearly transparent enough.

Although "quote stuffing" by definition involves high frequency trading, it is clear that not all high frequency trading is intended to have any impact on price or volume of stocks. In fact, many asset managers use high frequency trading algorithms and dark pools, which are electronic trading systems outside of formal exchange trading rules—including requirements to publish bid and offer quotes to the market, to efficiently negotiate large securities transactions ("block trades") without moving the price of the relevant stock. Similarly, asset managers use high frequency trading algorithms to break block trades into many smaller ones and disperse those trades through the market in a way that does not signal the size or direction of the investment decision. In this manner, high frequency trading can be seen as benefiting the market by increasing liquidity, limiting price volatility, and decreasing overall costs. By the beginning of October, the SEC, in partnership with the Commodity Futures Trading Commission ("CFTC"), will announce its conclusion about what caused the "flash crash" and, it's expected that the SEC will, soon thereafter, propose new regulations on high frequency trading.

II. SEC PROPOSED RULE ON RISK MANAGEMENT CONTROLS FOR BROKER-DEALERS WITH MARKET ACCESS - PROHIBITING "NAKED ACCESS"

Many exchanges have rules that impose requirements on "sponsored access" arrangements. These rules

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(including Nasdaq Rule 4611) generally require a broker-dealer (or "Sponsor") to establish contractual, systems, and procedural controls over third party access and trading on the exchange. However, given the increased speed and automation of trading on securities exchanges and alternative trading systems ("ATSs") that exist today, and the growing popularity of sponsored access arrangements, the SEC is concerned that the various financial and regulatory risks that arise in connection with such access may not be appropriately and effectively controlled by all broker-dealers. Among these risks, and of particular concern to the SEC, is the potential of sponsored access arrangements to amplify risks associated with algorithmic trading errors. In another move by the SEC to gain more control over high frequency traders, the SEC has proposed rules that affect a wide range of market participants.

In "sponsored" access arrangements, a Sponsor allows its customers—usually other broker-dealers, asset management firms on behalf of hedge funds or mutual funds, banks and other institutions ("Sponsored Participants")—to use the Sponsor's market participant identifier ("MPID") and provides the Sponsored Participants electronic access to an exchange or ATS of which the Sponsor is a member or subscriber. Sponsored access arrangements generally require a Sponsored Participant's orders to flow through the Sponsor's order management systems before passing into the markets, however some sponsored access arrangements permit a Sponsored Participant's orders to flow directly into the markets without first passing through the Sponsor's order management systems. In this situation, the access is "unfiltered" or "naked" because the Sponsor does not utilize any pre-trade risk management controls and may not be aware of the Sponsored Participant's trading activity or have a mechanism to control it. Regardless of whether the sponsored access is filtered or naked, the Sponsor remains responsible for all trading activity that occurs under its MPID.

In January 2010, the SEC proposed a new Rule 15c3-5 under the Securities Exchange Act of 1934 that would impose broad new requirements on broker-dealers that have direct trading access to an exchange or ATS, effectively prohibiting broker-dealers from providing customers, such as investment managers, with "unfiltered" or "naked" access to an exchange or ATS. The proposed rule would require broker-dealers to establish, document and maintain a system of risk management controls and supervisory procedures designed to manage the financial, regulatory and other risks related to their market access, including access on behalf of sponsored customers.

In particular, proposed Rule 15c3-5(c)(1) would require broker-dealers to implement risk management controls and supervisory procedures reasonably designed to systematically limit their financial exposure related to market access. These controls would need to be applied on an automated, pre-trade basis. As a practical matter, broker-dealers would not be able to achieve compliance with this "pre-trade monitoring requirement" without mandating that its customers' orders flow through the broker-dealer's order management systems before passing into the markets, thereby eliminating "unfiltered" or "naked" sponsored access for investment managers to any exchange or ATS. The proposed rule would also require broker-dealers to have controls and procedures reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds in the aggregate for each customer and the broker-dealer, among other requirements.

If adopted, proposed Rule 15c3-5 would significantly impact the ways market participants currently access the markets. Investment managers that rely on sponsored access arrangements are likely to experience delays in their order delivery to the markets as their Sponsors increase pre-trade screening and those with "naked access" will find their access re-routed through the Sponsor's monitoring systems. Given the reliance of many market participants on high speed and low cost executions in their trading strategies, proposed Rule 15c3-5 would affect a number of relationships among market participants, including asset managers' relationships with soft dollar and commission sharing arrangement counterparties.

III. SEC's EQUITY MARKET STRUCTURE CONCEPT RELEASE

On January 21, 2010, the SEC issued a concept release announcing that it is conducting a comprehensive review of equity market structure and seeking comments and suggestions ("Release"). The SEC is assessing whether market structure rules have kept pace with, among other things, changes in trading technology and practices. The review already has led to several rulemaking proposals that address particular issues, including a proposal to eliminate the exception for "flash orders" from the Exchange Act quoting requirements, one to address certain practices associated with non-public trading interest, including dark pools of liquidity on ATSs, and the initiative to address sponsored access discussed above. The major concern highlighted in the Release is high frequency trading, which the SEC does not define but notes that the lack of a clear definition complicates its broader review of market structure issues. The lack of clarity may, for example, contribute to the widely varying estimates of high frequency trading volume in today's equity markets.

High frequency traders could be organized in a variety of ways, including as a proprietary trading firm (which may or may not be a registered broker-dealer and member of FINRA), as the trading desk of an SEC registered broker-dealer or investment adviser, or as a hedge fund (all of which the SEC refers to collectively in the concept release as a "proprietary

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firm"). Other characteristics often attributed to proprietary firms engaged in high frequency trading are: (1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders; (2) use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) very short time-frames for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading day in as close to a flat position as possible (that is, not carrying significant, unhedged positions over-night). The Release raises many questions relating to high frequency trading, that hopefully will be discussed at length before any regulations inhibiting its use are adopted.

Fairness of Co-Location

The Release also addresses "co-location," which is a service offered by exchanges, ATSs and other markets ("trading centers") that operate their own data centers and by third parties that host the matching engines of trading centers. The trading center or third party rents space to market participants that enables them to place their servers in close physical proximity to a trading center's matching engine. Co-location helps minimize network and other types of latencies between the matching engine of trading centers and the servers of market participants.

The SEC Release focused on co-location that facilitates high frequency trading by reducing network and other latencies and permits firms to be faster than competitors. Many high frequency trading strategies, including those of asset managers using algorithm based cross-asset or inter-market spreading strategies, are highly dependent upon speed — speed of market data delivery and access from trading center servers to servers of the high frequency trading firm; speed of trading engines of the proprietary firm; and speed of order execution and response by trading centers. Speed matters both in the absolute sense of very low latencies and in the relative sense of being faster than competitors, even if only by a microsecond. Co-location is one means to save micro-seconds of latency.

The SEC states that it believes co-location services offered by registered exchanges are subject to the Exchange Act, and that registered exchanges must file and receive SEC approval of proposed rule changes before offering co-location services to customers. The terms of such co-location services must not be unfairly discriminatory, and the fees must be equitably allocated and reasonable.

Price Discovery—Undisplayed Liquidity and Dark Pools

The SEC states that it appears that a significant percentage of the orders of long-term investors are executed either in dark pools or at over-the-counter market makers, while a large percentage of the trading volume in displayed trading centers is attributable to high frequency trading firms executing short-term trading strategies. The SEC is concerned about whether the trading volume of undisplayed liquidity has reached a sufficiently significant level that it has detracted from the quality of public price discovery and execution quality. For example, has the level of undisplayed liquidity led to increased spreads, reduced depth, or increased short-term volatility in the displayed trading centers? If so, has such harm to public price discovery led to a general worsening of execution quality for investors in undisplayed markets? If the quality of public price discovery has been harmed by undisplayed liquidity, then the SEC seems to be considering a few regulatory tools to address the problem. One is a "trade-at" rule that would prohibit any trading center from executing a trade at the price of the national best bid or offer ("NBBO") unless the trading center was displaying that price at the time it received the incoming contra-side order. Another is expanding trade-through protection under Rule 611 of Regulation NMS to include the displayed "depth-of-book" quotations of a trading center.

Fair Access and Regulation ATS

A significant difference between the undisplayed liquidity offered by exchanges and the undisplayed liquidity offered by dark pools and broker-dealers is the extent of access they allow to such liquidity. Rule 301(b)(5) of Regulation ATS requires ATSs that have five percent or more of the average daily trading volume in an NMS stock for four of the preceding six calendar months to establish written standards for granting access to their trading systems and to apply such standards in a fair and nondiscriminatory manner. The Release asks whether the fair access threshold should be lowered from the five percent threshold. The SEC recognizes that dark pools have the objective of enabling institutional investors, such as asset managers, to trade in large size with minimal price impact and questions the ability of dark pools to comply with the fair access requirement while still enabling institutional investors to meet this objective. The dark pool restrictions designed to prevent predatory trading behavior may be compromised by application of the fair access standards.

IV. PROPOSED MARKET STRUCTURE REFORM—WHAT ASSET MANAGERS SHOULD CONSIDER NOW

Given the current regulatory focus, asset managers should assess their current arrangements relating to trade execution, related processes for risk management, and prepare contingency plans for alternative arrangements if limits or bans on high frequency trading or "naked" sponsored access are imposed. Among other questions to be considered are: (1) Do we have in place soft dollar or commission sharing arrangements with broker-dealers that provide "naked" sponsored access?; (2) What would be

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the effect if those "naked" sponsored access arrangements are prohibited and our choice of research providers under soft dollar or commission sharing arrangements becomes limited to those broker-dealers to which we direct order flow through their order management and "filtering" systems?; (3) What other alternatives do we have for accessing trading markets, including registering our own broker-dealer?; and (4) If a large percentage of our trading strategies involve algorithmic high frequency trading, will those strategies remain successful and profitable if the proposed regulations on high frequency trading and co-location being considered are adopted? These and other questions should be considered, as we await the SEC and CFTC report on the May 6 "flash crash" and further regulations that could limit not only access to liquidity and market venues, but also the types of trading strategies and investment methodologies used to invest on behalf of clients.

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UPCOMING EVENTS:

October 4	Ethics: IA Code of Ethics *In person: Scottsdale*
October 4	Ethics: Ethical Decision-Making *In person: Scottsdale*
October 4	Ethics: Mastering Critical Skills *In person: Scottsdale* and *Online 1:00 p.m. - 3:00 p.m. (ET)*
October 5	Disclosure: Form ADV Part 1 & Reg Reporting *In person: Scottsdale*
October 5	Disclosure: Form ADV Part 2 & Identify/Disclose *In person: Scottsdale*
October 5	Disclosure: IA Performance and Advertising *In person: Scottsdale*
October 7	Professional Ethics *In person: Scottsdale* and *Online 1:00 p.m. - 3:00 p.m. (ET)*
October 26	RIA-Year End Compliance Check-Up *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 2	Advisers Act: Framework of the Act—Duty to Supervise; Who Must Register; Exclusions and Exemptions; State and Federal Responsibilities *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 4	Advisers Act: Books and Records—Today's Requirements *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 9	Advisers Act: Brochure Rule; Insider Trading; Codes of Ethics; Contracts *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 16	Advisers Act: Anti-Fraud Rules—Fiduciary Duty, Principal and Agency Cross Transactions, Pooled Investment Vehicles, Advertising Rule *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 18	Advisers Act: Anti-Fraud Rules—Custody, Solicitors, Financial and Disciplinary Disclosure, Proxy Voting *Online 1:00 p.m. - 3:00 p.m. (ET)*
November 30	Advisers Act: Anti-Fraud Rules—Compliance Programs Rules and Mastering the Annual Review *Online 1:00 p.m. - 3:00 p.m. (ET)*
December 2	IACCP Exam Study Session *Online 1:00 p.m. - 4:00 p.m. (ET)*
December 7	Investment Adviser Regulatory Update *Online 1:00 p.m. - 3:00 p.m. (ET)*
December 14	The Architecture of a Sustainable IA Compliance Program *Online 1:00 p.m. - 3:00 p.m. (ET)*