

SEC's Market Structure Initiatives Continue

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At an open meeting on January 13, 2010, the Securities and Exchange Commission ("Commission" or "SEC") voted to publish for public comment two releases:

- A proposed rule regarding sponsored access ("Proposed Rule"); and
- A concept release ("Concept Release") requesting comment on various market structure developments – in particular, the performance of the current market structure, tools and trading strategies employed in high frequency trading ("HFT"), and so-called "dark" liquidity.

This Alert summarizes the discussion regarding the Proposed Rule and the Concept Release, as well as comments made and questions raised at the open meeting.¹ We anticipate publishing more detailed overviews of the Proposed Rule and the Concept Release when they are published for public comment.

I. Risk Management Controls for Broker-Dealers with Market Access

A. Proposed Rule

The Proposed Rule would require broker-dealers with market access or that provide market access to customers or others to establish reasonably designed pre-trade risk management controls and supervisory procedures. Specifically, the Proposed Rule would require broker-dealers to:

- Create financial risk management controls reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous;
- Create regulatory risk management controls reasonably designed to ensure compliance with all regulatory requirements applicable in connection with market access;
- Have financial and regulatory risk management controls applied automatically on a pre-trade basis before orders route to an exchange or alternative trading system ("ATS");

- Maintain risk management controls and supervisory procedures under the direct and exclusive control of the broker-dealer with market access; and
- Establish, document and maintain a system for regularly reviewing the effectiveness of its risk management controls and for promptly addressing any issues.

As a result, the Proposed Rule effectively would prohibit broker-dealers from providing customers with so-called "naked" or otherwise "unfiltered" access to an exchange or ATS. As described at the open meeting, the proposed risk management controls would apply not only to naked or unfiltered market access arrangements, but also to broker-dealer proprietary and agency trading.

The Proposed Rule is intended to require broker-dealers to implement effective financial and regulatory risk management controls and supervisory procedures on a market-wide basis in order to reduce the chances of erroneous order entry, potential breaches of credit or capital limits, and failures to comply with regulatory requirements regarding risk management. It would apply to market access involving all securities, including stocks, options, exchange traded funds ("ETFs") and debt securities. It would entail an annual CEO certification process. Notably, it also would prohibit broker-dealers from delegating any of these compliance and certification responsibilities to a customer or third party. The SEC Staff clarified that broker-dealers currently are obligated to have risk management controls in place, and that therefore it expects that many, if not all, broker-dealers already have sufficient risk management controls to comply with the Proposed Rule's requirements.

B. Comments and Issues Raised at the Open Meeting

The Commissioners expressed interest in receiving public comment on a number of issues related to the Proposed Rule, including, among others:

- How it would affect trading activity and market performance;
- The costs and benefits of the Proposed Rule, particularly for small broker-dealers;
- The extent to which broker-dealers' business models rely on sponsored access; and
- Data regarding average trading volume currently associated with naked access arrangements (at the open meeting, the Commissioners and Staff noted that a recent report estimates that naked access accounts for 38% of the average daily trading volume for equities in US markets).

The Commissioners and Staff specifically acknowledged the efforts by self-regulatory organizations ("SROs") regarding sponsored access, and in particular commended the Nasdaq proposed sponsored access rule, approval of which the Commission announced during the open meeting. The Staff noted, however, that it believes the SEC's Proposed Rule would go further than the Nasdaq rule because it would require a broker-dealer to apply controls on a pre-trade basis, would preclude broker-dealers from outsourcing the Proposed Rule's compliance function to customers

or a third party, would require a supervisory system, including the annual CEO certification, and would apply market-wide whenever a broker-dealer directly accessed any exchange or ATS.

Comments on the Proposed Rule are due within 60 days after publication in the Federal Register.

II. Concept Release

A. Topics

The Concept Release on equity market structure will provide an overview of the current US market structure, describe how it has changed over the years, and ask questions about how it has performed in recent years. It also will discuss HFT, including the various tools and strategies employed in HFT, such as the use of co-location arrangements and direct market data feeds. The Staff also indicated that the Concept Release will discuss non-displayed or dark liquidity, including the extent to which the volume of dark versus "light" liquidity has shifted, the changing nature of dark liquidity over the past several years, and the various types of dark liquidity in the markets, such as, among others, dark pool ATSs and undisplayed order types on exchanges and electronic communications networks ("ECNs"). The Concept Release will request information regarding a variety of issues, including requests for data regarding execution quality and other market quality metrics. It also will seek comments as to whether recent market changes have improved or degraded elements of US market structure, such as price discovery.

B. Comments and Issues Raised at the Open Meeting

The Commissioners expressed interest in receiving public comment on a number of issues related to the Concept Release, including, among others:

- Data regarding the performance of current market structure, HFT, and dark liquidity;
- Appropriate means for assessing how different types of investors have fared in the markets;
- Whether the current market structure is fundamentally fair to investors and supports capital raising functions for companies of various sizes, and whether intermarket linkages are adequate to provide a cohesive national market system;
- The impact of HFT on overall market performance, the various tools or strategies used in HFT, and whether the SEC should take steps to curb or otherwise regulate certain tools or strategies commonly used with HFT, such as co-location; and
- The impact of the increase in dark liquidity on overall market performance.

The Commissioners expressed particular interest in receiving comments from a wide range of market participants.

Comments on the Concept Release are due within 90 days after publication in the Federal Register.

III. Implications

The Proposed Rule and Concept Release are the most recent components of the SEC's ongoing examination of US market structure issues and developments. In September 2009, the Commission proposed an amendment to Rule 602 of Regulation NMS eliminating the exception for the use of flash orders.² In November 2009, the Commission proposed rule changes regarding non-displayed liquidity, including amending the definition of "bid" and "offer" in Rule 600 of Regulation NMS such that they apply explicitly to actionable indications of interest, amending the trading volume threshold triggering display requirements under Regulation ATS from 5% to 0.25%, and amending the joint-industry plans for publicly disseminating consolidated trade data to require real-time disclosure of the identity of dark pools and other ATSS on their trade reports.³ Market participants interested in such issues should monitor Commission developments regarding these rule proposals, as well as industry, regulatory, and legislative responses to the Concept Release.

¹ This Alert is not intended to serve as a verbatim memorialization of the open meeting, a webcast of which can be viewed [here](#). See also SEC press releases regarding the new proposed rule and concept release, which can be viewed [here](#).

² Exchange Act Rel. No. 60684 (Sept. 18, 2009), 74 Fed. Reg. 48632 (Sept. 23, 2009).

³ Exchange Act Rel. No. 60997 (Nov. 13, 2009), 74 Fed. Reg. 61208 (Nov. 23, 2009).

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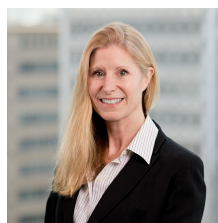
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