

## SEC Issues Concept Release on Equity Market Structure

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### Introduction

The Securities and Exchange Commission (the “**SEC**” or the “**Commission**”) has issued a [concept release](#) that is the cornerstone of its review of equity market structure. The 74-page concept release<sup>1</sup> seeks comment on a broad range of issues, many of which have arisen since the implementation of the Commission’s Regulation NMS.<sup>2</sup>

In the concept release, the SEC requests public comment on literally hundreds of questions on equity market structure performance (in particular for “long-term investors”), high frequency trading, and undisplayed liquidity. However, not all questions are created equal. What follows is our view of the questions that are most revealing of the SEC’s thinking or that have the most significant potential impact for broker-dealers, proprietary trading firms, exchanges, and other market participants.

The concept release is part of an ongoing SEC review of the equity markets.<sup>3</sup> We await proposals regarding enhanced large-trader reporting, as well as a final short-sale price restriction rule, which Chairman Schapiro has said will be brought to a Commission vote in February. In another sign of what the future may hold, at the open meeting on the concept release Commissioner Walter pointedly stated that the structure of the fixed-income market is also in need of a regulatory review.

### Key Issues

#### Expansion of execution quality statistics and disclosures regarding order routing services

The SEC asks whether Rule 605 and Rule 606 reporting standards should be modified.<sup>4</sup> The multiple detailed questions about specific order routing statistics implies that the SEC intends to update its required statistics. Questions about statistics measuring commission costs of orders, access fees, or liquidity rebates suggest the SEC may ultimately seek to increase disclosure of these costs to customers. Furthermore, questions about institutional investors’ access to information about the smart order routing services and order algorithms offered by their brokers clearly reflect SEC concerns that institutions are not aware of how their orders are publicized to others and when they interact with the broker-dealers’ proprietary interest.

Changes to these disclosure requirements would require reprogramming by market centers and other broker-dealers that execute or route orders. In addition, investment managers and order routing firms would need to reevaluate their best execution methodologies to take into account the availability of new statistics and other information that may be relevant to their decision making.

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<sup>1</sup> Exchange Act Release No. 61358 (Jan. 14, 2010).

<sup>2</sup> Exchange Act Release No. 51808 (June 9, 2005).

<sup>3</sup> In the last several months, the Commission has proposed a ban on flash orders ([Exchange Act Release No. 60684](#)) (Sept. 18, 2009)) and measures that will illuminate certain dark pools ([Exchange Act Release No. 60997](#) (Nov. 13, 2009)). Also, in companion actions to its issuance of the concept release, the SEC approved a NASDAQ rule change ([Exchange Act Release No. 61345](#) (Jan. 13, 2010)) and proposed a new Commission rule concerning sponsored access.

<sup>4</sup> Rule 605 requires market centers to publish standardized, monthly statistics on their execution quality in NMS stocks, and Rule 606 requires broker-dealers to publish reports on their order routing and payment for order flow practices in NMS securities.

## Regulation of high frequency trading

The SEC asks generally whether high frequency trading is helpful or hurtful to the market, particularly long-term investors in the market. The SEC emphasizes that while high frequency and proprietary trading has grown, the equity markets functioned well during the market stresses of the fall of 2008. This suggests that the SEC is focused on potentially refining rather than eliminating high frequency trading. In this context, the SEC explores several significant changes to this mode of trading.

### Imposition of affirmative/negative obligations on proprietary traders

The SEC notes that the “use of certain strategies by some proprietary firms has, in many trading centers, largely replaced the role of specialists and market makers with affirmative and negative obligations.” The SEC also voices its deep-seated concern that certain trading strategies of proprietary trading firms may be “phantom liquidity that disappears when most needed by long-term investors and other market participants.”

In light of this concern, the SEC asks whether proprietary trading firms should be subject to affirmative or negative trading obligations that are designed to promote market quality and prevent harmful conduct. As an example of affirmative obligations, the SEC cites the requirement to display consistently high quality, two-sided quotations, and as an example of negative obligations, the SEC cites a restriction on “reaching across the market” to execute against displayed quotations.

These obligations would pose a substantial regulatory and economic burden for most proprietary trading firms. It may be incumbent on proprietary trading firms to submit data that demonstrates that their form of trading is not detrimental to the quality of the markets and promotes price discovery, dampens volatility, and provides liquidity on an ongoing basis.

### Broker-dealer registration for proprietary traders

As a means to address systemic risk, the SEC asks whether all proprietary firms should be required to register as broker-dealers and become members of FINRA to help assure that their operations are subject to full regulatory oversight. Requiring broker-dealer registration for all proprietary trading firms would be a significant shift, and would add compliance costs and burdens to those firms.

This question, however, should be viewed in light of public statements that the SEC will soon be proposing that high frequency trading firms be required to register with the SEC as large traders under Section 13(h) of the Securities Exchange Act. If the large trader proposal is ultimately adopted, it would provide regulators with much of the key trading information that broker-dealer registration would entail.

### Co-location and latency disclosures

As anticipated, the SEC asks a number of questions regarding co-location of trading operations, several of which are revealing of the SEC’s thinking. For one, the SEC questions whether “co-location services fundamentally differ from other respects in which market participants can obtain latency advantages, particularly if co-location services are not in short supply and are available to anyone on terms that are fair and reasonable and not unreasonably discriminatory.”

This suggests that the SEC believes that co-location is not a negative feature of market structure in and of itself. The SEC also notes that the benefits of co-location can be obtained by location just outside the trading facility. However, to the extent feasible, the SEC will focus on ensuring that co-location services are offered consistent with the SEC’s long-standing “fair access” requirements.

The SEC asks whether all or some market participants (such as proprietary firms) that obtain co-location services should be subject to any affirmative or negative obligations, similar to exchange specialists and other registered market makers.

In addition, the SEC asks whether it should require latency disclosure by exchanges and ECNs with respect to order execution. Such disclosure could spur new rounds of competition (and disputes) among markets regarding advertised execution latencies.

### **Regulation of negative trading strategies**

The SEC identifies a number of different trading strategies utilized by high frequency traders and questions the impact of certain of those strategies on the market. In the context of its discussion of “order anticipation” trading strategies, the SEC reiterates its views on front-running, stating that it is prohibited conduct to violate a duty to, or misappropriate information from, a large buyer or seller and then use such information for a firm’s own trading to the detriment of the large buyer or seller.

The SEC also states that “momentum ignition” strategies may be manipulative. The SEC asks whether there are regulatory tools (beyond the currently applicable anti-fraud and anti-manipulation provisions) that would effectively reduce or eliminate the use of “order anticipation” and “momentum ignition” strategies. In addition, the SEC questions whether momentum strategies that react to orders in the market actually harm the market by soaking up available liquidity and thereby making it more expensive to long-term investors to buy or sell securities.

Underlying the importance of this issue, the SEC identifies as a key issue whether the current market structure and the availability of sophisticated, high-speed trading tools enable proprietary firms to engage in order anticipation strategies on a greater scale than in the past. Proprietary traders should expect a heightened regulatory (and perhaps enforcement) focus on these activities.

### **Undisplayed Liquidity**

#### **Market impacts**

For several years, the SEC staff has believed that the growth of dark pools was not problematic because it merely reflected a shift in trading from other dark venues without the total percentage of trading volume in dark venues growing significantly. In the concept release the SEC describes this ongoing pattern but asks whether it masks potentially important changes in the routing of various types of order flow. In particular, the SEC asks if long-term investor order flow is shifting to dark pools and OTC market makers while the public markets are executing an expanding volume of high frequency trading, and if so, whether this affects the quality of public price discovery. In public remarks, SEC staff also have asked whether this shift increases short-term volatility.

The way in which the SEC resolves these questions will have a significant effect for future years on its approach to regulation. To prevent a general concern from becoming an axiom on which policies are based, market participants should communicate their views, where possible with data, on these issues to the SEC.

Interestingly, the concept release only fleetingly mentions reserve orders and similar order types, presumably because the SEC does not perceive these to raise the same concerns as other market mechanisms.

#### **A “trade-at” rule and depth-of-book order protection**

To address concerns on undisplayed liquidity, the SEC asks whether it should consider a trade-at rule that would prohibit any trading center from executing a trade at the price of the NBBO unless the trading center was displaying that price at the time it received the incoming contra-side order.

Contemplation of a trade-at rule is not novel for the SEC, as it was considered during the Regulation NMS comment period and in the SEC’s 2000 fragmentation release. A trade-at rule would encourage quote competition by requiring a trading center to quote aggressively or offer price improvement to retain order flow. However, a trade-at rule would overturn decades of market structure developments: it would eliminate dark pools, severely curtail the activities of wholesale market makers, and dramatically change the terms of competition between public markets.

While breathtaking in impact, the trade-at rule should not be assumed dead on arrival. The detailed questions posed by the SEC show that it has thought deeply about this issue. The concept release also discusses potential expansion of the trade-through rule to provide trade-through protection to the

displayed “depth-of-book” quotations of a trading center, which could also have significant competitive impact.

## Other Questions

In addition to the issues noted above, the concept release addresses a multitude of other questions, issues and sub-issues. We found the following points on which it requests comment to be among the most noteworthy and possibly suggestive of SEC thinking:

### Trading Strategies

- Should there be a minimum requirement on the duration of orders (such as one second) before they can be cancelled?
- Should the use of “pinging” orders by all or some traders to assess undisplayed liquidity be prohibited or restricted in all or some contexts?

### Latency of Consolidated Data

- Is the existence of any latency, or the disparity of information transmitted, fair to investors or other market participants that rely on the consolidated market data feeds and do not use individual trading center data feeds?
- If so, should the unfairness be addressed by a requirement that trading center data be delayed to assure that consolidated data reaches users first?

### Undisplayed Liquidity

- If investors were limited in their ability to use undisplayed liquidity, how would trading behavior change, if at all?
- Many dark pools execute orders with reference to the displayed prices in public markets. Does this create opportunities for institutional investors to be treated unfairly by improper behavior?

### Low-Priced Stocks

- Should the SEC consider reducing the minimum pricing increment in Rule 612 for lower priced stocks?

### Regulation of ATSS

- Do investors have sufficient information about dark pools to make informed decisions? Should dark pools be required to provide improved transparency on their trading services and the nature of their participants?
- Should the trading volume threshold in Regulation ATS that triggers fair access requirements be lowered from its current 5%?

## Conclusion

The questions and comments raised by the SEC in the concept release could result in proposals that would drastically change the structure in the equity trading markets. Market participants should carefully consider the main questions raised in the concept release and weigh the merits of submitting comment letters. The comment period for the concept release ends on April 21, 2010.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

<b>Annette L. Nazareth</b>	202 962 7075	<a href="mailto:annette.nazareth@davispolk.com">annette.nazareth@davispolk.com</a>
<b>Lanny A. Schwartz</b>	212 450 4174	<a href="mailto:lanny.schwartz@davispolk.com">lanny.schwartz@davispolk.com</a>
<b>Gerard Citera</b>	212 450 4881	<a href="mailto:gerard.citera@davispolk.com">gerard.citera@davispolk.com</a>
<b>Robert L.D. Colby</b>	202 962 7121	<a href="mailto:robert.colby@davispolk.com">robert.colby@davispolk.com</a>

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