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SECURITIES INDUSTRY PRACTICE

# ALERT

## SEC Adopts New Rule Preventing Unfiltered Market Access

On November 3, 2010, the Securities and Exchange Commission (SEC) voted unanimously to adopt a new rule requiring broker-dealers to implement risk controls before they provide customers with electronic access to the equities markets. The new rule will effectively end so-called "naked" (or "unfiltered") access by customers to the markets, and is part of a larger effort by the SEC "to help ensure the markets are fair, transparent and efficient."

Specifically, the rule prohibits broker-dealers from providing customers with unfiltered access to an applicable exchange or alternative trading system (ATS). It requires brokers who directly access an exchange or an alternative trading system — including those who "sponsor" customers' access to same — to put in place financial and regulatory risk management controls and supervisory procedures that are "reasonably designed to prevent the entry of orders that exceed appropriate pre-set credit or capital thresholds, or that appear to be erroneous." Among other things, these controls must include the programming and implementation of pre-order-entry filters by brokers in their own systems for orders directed either by them or their customers to the equities markets.

This issue of unfiltered access has been the subject of much debate, especially involving the high-frequency trading firms that use algorithms and high-speed and high-capacity computers to capture minimal and fleeting arbitrage (and other quantitative) opportunities in the markets. Some observers have estimated that such activity constitutes upwards of 70 percent of the volume traded in U.S. equity markets today.

Broker-dealers have eight months — which includes 60 days from publication of the rule in the *Federal Register* plus an additional six months — to comply with this new rule.

If you have any questions regarding the information in this alert, please contact:
Ernest E. Badway at 973.548.7530 or 212.878.7900; ebadway@foxrothschild.com
William M. Dailey at 203.425.1591; wdailey@foxrothschild.com
Joshua Horn at 215.299.2184; jhorn@foxrothschild.com
Joseph M. Pastore III at 203.425.1504; jpastore@foxrothschild.com
or any other member of our Securities Industry Practice Group.

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