

Client Alert

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Our Modern Markets: SEC Enforcement Focuses On Market Structure In Response To Rapidly-Changing Equity Markets

On Monday, November 2, 2015, Andrew Ceresney, Director of the SEC's Division of Enforcement, gave a speech at the SIFMA Compliance & Legal Society New York Regional Seminar in which he sought to address what he views as the future of SEC enforcement and the existing risks created by technology and innovation in equity markets.¹ Mr. Ceresney highlighted that, "[w]ith the passage of Regulation NMS in 2007, the increase in the number of exchanges and other trading venues, the automation of nearly all equity trading, and the emergence of high frequency and algorithmic trading, market structure issues—especially technology-related issues—have taken on increased prominence."²

Gone are the days when the majority of trading was done on the New York Stock Exchange trading floor, and when the handful of exchanges and markets each were self-regulatory organizations themselves or had a SRO affiliate. Today's modern markets employ technology to effectuate trades in microseconds. The automation of trading has led to faster trades, fewer shares per trade, and increased diversity in trading venues.³ "Competition for order flow among these trading venues is intense. Venues strive to show that they offer low-costs, liquidity, price improvement, and speed of execution. Much of that order flow now comes from high frequency trading firms. Typical estimates are that high frequency trading represents 50% or more of total market volume."⁴ And most self-regulation is now out-sourced to FINRA, which can leverage its multiple-market regulatory experience.

As a result, the SEC has "brought a growing number of market structure enforcement cases in recent years."⁵ Expecting this pattern to continue, Mr. Ceresney's speech focuses on four key threats to the integrity of our modern equity markets: (1) "fairness in trading venues" and adherence to SEC rules; (2) "misuse of confidential customer order information"; (3) failure to adopt policies and procedures to comply with the Market Access Rule and protect against risks of so-called out-of-control automation; and (4) "high-volume manipulative trading."⁶ The SEC has been focused on market structure issues from a regulatory and enforcement perspective for a number of years, as the collection of enforcement actions highlighted in Mr. Ceresney's speech demonstrates. Packaging these cases together to make his point also foreshadows that this area will remain in sharp focus going forward.

The History of Market Structure Enforcement

Fair Trading Venues

Prior to 2012 “the SEC had never imposed a single civil penalty on a national stock exchange,”⁷ yet since 2012, nine exchanges have been involved in seven different enforcement settlements leading to millions in civil penalties.⁸ Enforcement actions have scrutinized operational issues at exchanges⁹ and information-sharing inequities that affect the integrity of the market.¹⁰ Additional concerns focus on the growth of dark pools¹¹ and other Alternative Trading Systems (“ATSS”), which are not subject to the same rules as exchanges. For example, in a recent enforcement action UBS was required to pay \$14 million in disgorgement and civil penalties for offering sub-penny trades (which violate Regulation NMS) to its dark pool customers.¹² Mr. Ceresney stated, “[t]he takeaway from these cases is that the Commission will enforce its rules vigorously to ensure that trading venues operate fairly and that customers receive the accurate information they need to make trading decisions.”¹³

Misuse Of Confidential Customer Information

Mr. Ceresney expressed further concern regarding the protection of customer order information. Previous enforcement actions have imposed penalties on entities for: (1) using confidential information about dark pool subscribers to target marketing efforts,¹⁴ (2) using confidential order information collected on an ATS to aid other customers’ trading,¹⁵ and (3) operating a proprietary trading desk that had access to live feeds of subscriber trade data.¹⁶ Mr. Ceresney warned that the SEC’s Enforcement Division “will act whenever [it] see[s] this sort of abuse of customer trust.”¹⁷

Market Access

Another key issue and focus of SEC enforcement is what Mr. Ceresney referred to as “out-of-control automation.” Implemented in 2011, Rule 15c3-5, commonly known as the “market access rule,” requires brokers and dealers to maintain risk management controls and procedures to manage financial risk (to prevent erroneous orders or orders exceeding capital limits) and regulatory risk (to ensure compliance with rules both pre and post-trade).¹⁸ With five enforcement cases brought in the last two years, enforcement related to automated trading issues is a “particularly active area” as the SEC seeks to ensure that proper safeguards are in place on automated trading systems.¹⁹ Mr. Ceresney discussed the most notable enforcement action of this type, involving a computer malfunction at Knight Capital, wherein the SEC found that Knight Capital’s order router traded nearly 400 million shares in 45 minutes, acquiring billions of dollars in positions by mistake.²⁰ While systems glitches involving erroneous orders are common, Mr. Ceresney also cited enforcement actions against Morgan Stanley and Latour Trading to make the point that safeguards must be bolstered by adherence to controls and adoption of procedures to modify those controls.²¹ In short, according to Mr. Ceresney, firms must have “safeguards in place that anticipate mistakes and limit the harm they can cause.”²²

High Volume Manipulation

Finally, Mr. Ceresney expects that high-volume manipulative trading will continue to be a focus of SEC enforcement actions. Practices such as “marking the close,” described as placing trades near the close of trading to affect the trading price, and “layering” or “spoofing,” described generally as schemes where “the trader sends non-bona fide orders that he or she intends to cancel before they are executed in order to induce others to buy or sell securities at prices that do not represent actual supply and demand,”²³ have been penalized.²⁴ Although Mr. Ceresney noted that these cases can be challenging to bring due to the large volume of order and trade data required to be analyzed, he also noted that the SEC has the “expertise and resources” to do so through use of “innovative data analytics.”²⁵

The Future of Market Structure Enforcement and Best Practices for Market Participants

In conclusion, Mr. Ceresney promised continued focus on the threats he identified. He noted that the SEC “will remain diligent in looking at various trading venues, including dark pools. . . . [and] continue to focus on market access [rule] violations.”²⁶ Mr. Ceresney further added that “[w]e will be particularly interested in whether broker-dealers are fulfilling their obligations both for pre-trade regulatory requirements and also post-trade surveillance.” Finally, both the SEC and market participants must develop a greater understanding of “the technology that forms the backbone of our markets” which includes an understanding of “the computer codes that direct those systems.”²⁷

Mr. Ceresney’s speech serves as a clear roadmap of the SEC’s outlook on the future of enforcement with regard to equity markets. While technology facilitates increased sophistication and innovation in equity markets, the SEC is committed to ensuring that market integrity is maintained. Market participants, and particularly broker-dealers who Mr. Ceresney describes as the “gateways and gatekeepers”²⁸ to the markets, can protect themselves from enforcement actions by proactively reviewing their policies and procedures governing trading controls, surveillance and market access for compliance with the current regulatory scheme, and effectiveness.

One or more of the authors represented clients in some of the enforcement settlements referenced herein.

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¹ Andrew Ceresney, Director, Division of Enforcement, Securities and Exchange Commission, “Market Structure Enforcement: Looking Back and Forward,” SIFMA Compliance & Legal Society New York Regional Seminar, *available at* <http://www.sec.gov/news/speech/ceresney-speech-sifma-ny-regional-seminar.html>.

² *Id.* at 1

³ *See Id.* at 2 (*citing* BATS U.S. Stock Exchanges, Market Volume Summary, *available at* http://www.batstrading.com/market_summary/ (“Market Volume Summary”)). Mr. Ceresney noted that there are 11 different equity exchanges that compete for market share, yet still comprise only two-thirds of the total market share.

⁴ *See* Ceresney, *supra* note 1, at 2 (*citing* Staff of the Division of Trading and Markets, “Equity Market Structure Literature Review, Part II: High Frequency Trading” (March 18, 2014), *available at* https://www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf).

⁵ *See* Ceresney, *supra* note 1, at 1.

⁶ *Id.* at 1-2.

⁷ *See, e.g.*, In the Matter of National Association of Securities Dealers, Inc., Securities Exchange Act Release No. 37538 (August 8, 1996) (SEC found that NASD failed to enforce compliance with prohibitions against market makers coordinating quotes; NASD consented, without admitting or denying the findings, to a censure and to undertake various remedial measures so-ordered by the SEC); In the Matter of New York Stock Exchange, Inc., Securities Exchange Act Release No. 41574 (June 29, 1999) (SEC found that the NYSE failed to enforce compliance with prohibitions against profit-sharing or other performance-based compensation of independent floor brokers and failed to maintain random as well as for-cause surveillance of floor brokers for some periods; the NYSE undertook various remedial measures so-ordered by the SEC, with no censure or other sanction); In the Matter of New York Stock Exchange, Inc., Securities Exchange Act Release No. 51524 (April 12, 2005) (SEC found that the NYSE failed to enforce compliance with prohibitions against “interpositioning” and “trading ahead” of customer orders; the NYSE consented, without admitting or denying the findings, to an SEC cease and desist order imposing a censure and agreed to several “significant remedial measures”).

⁸ *See* Ceresney, *supra* note 1, at 3.

⁹ *See, e.g.*, In the Matter of EDGX Exchange, Inc., EDGA Exchange, Inc. and Direct Edge ECN LLC, Exchange Act Release No. 65556 (Oct. 13, 2011) (no penalty for internal control problems resulting systems outage); In the Matter of The Nasdaq Stock

Market, LLC and NASDAQ Execution Services, LLC, Exchange Act Release No. 69655 (May 29, 2013) (\$10 million penalty for violations of internally-adopted rules leading to operational problems with the Facebook IPO).

¹⁰ See, e.g., In the Matter of EDGA Exchange, Inc. and EDGX Exchange, Inc., Exchange Act Release No. 74032 (Jan. 12, 2015) (\$14 million penalty); In the Matter of New York Stock Exchange LLC and NYSE Euronext, Exchange Act Release No. 67857 (Sep. 14, 2012) (\$5 million penalty for releasing trade data to proprietary customers before the larger market).

¹¹ Dark pools are trading markets created to allow large investors to make large trades without affecting the market pricing. Dark pools continue to face increased scrutiny and advocacy groups have lobbied the SEC for stronger disclosures. See Sarah N. Lynch, “Rules for ‘dark pool’ trading need strengthening,” REUTERS, (Sept. 15, 2015) available at

<http://www.reuters.com/article/2015/09/15/us-sec-darkpools-report-idUSKCN0RF1EP20150915>. Indeed, Nasdaq recently announced that it developed a dark pool surveillance tool that will work with one of its existing trade-monitoring platforms. See “Nasdaq’s SMARTS Launches Trade Surveillance Monitoring for Dark Pools,” GLOBENEWSWIRE (Oct. 8, 2015) available at <http://www.nasdaq.com/press-release/nasdaqs-smarts-launches-trade-surveillance-monitoring-for-dark-pools-20151008-00252>

¹² See In the Matter of UBS Securities LLC, Exchange Act Release No. 74060 (Jan. 15, 2015).

¹³ See Ceresney, *supra* note 1, at 4.

¹⁴ See In the Matter of Liquidnet, Inc., Exchange Act Release No. 72339 (June 6, 2014).

¹⁵ See In the Matter of LavaFlow, Inc., Exchange Act Release No. 72673 (July 25, 2014).

¹⁶ See In the Matter of ITG Inc. and Altnet Securities, Inc., Exchange Act Release No. 75672 (Aug. 12, 2015).

¹⁷ See Ceresney, *supra* note 1, at 5.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* (citing In the Matter of Knight Capital Americas LLC, Exchange Act Release No. 70694 (Oct. 16, 2013)). See also Nathaniel Popper, “Knight Capital Says Trading Glitch Cost It \$440 Million,” DEALBOOK (Aug. 2, 2012) available at http://dealbook.nytimes.com/2012/08/02/knight-capital-says-trading-mishap-cost-it-440-million/?_r=0 (reporting that Knight Capital lost “\$10 million a minute” due to new trading software that had been installed).

²¹ See Ceresney, *supra* note 1, at 6 (citing In the Matter of Morgan Stanley & Co. LLC, Exchange Act Release No. 73801 (Dec. 10, 2014)). A \$4 million penalty was imposed on Morgan Stanley for placing orders that required an increase of a certain customer’s credit limit without adequate diligence and in violation of Morgan Stanley’s credit limit policies. *Id.*

²² See Ceresney, *supra* note 1, at 6.

²³ *Id.* at 7.

²⁴ See, e.g., In the Matter of Athena Capital Research, LLC, Exchange Act Release No. 73369 (Oct. 16, 2014) (penalizing the firm for employing an algorithm that allowed it to systematically mark the close and artificially push market prices); In the Matter of Briargate Trading, LLC and Eric Oscher, Exchange Act Release No. 76104 (Oct. 8, 2015) (penalizing the firm and one of its founders for engaging in spoofing).

²⁵ See Ceresney, *supra* note 1, at 7.

²⁶ *Id.* at 8.

²⁷ *Id.*

²⁸ *Id.*