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Market Volatility and Enforcement Considerations Lead SEC to Propose New Trading Measures

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Even before the trading flare-up earlier this month, it was clear that rapid technological advances have fundamentally changed the U.S. securities markets including their structure, trading strategies utilized, products traded, and the types of participants.[1] As a result of these significant changes, institutional and other professional market participants now have the ability to use highly sophisticated trading methods to trade electronically huge volumes of securities very quickly. High frequency trading has, in fact, become increasingly prominent – some estimates have even indicated that "high frequency traders" currently account for over 50% of total market volume. Such trading activities, coupled with recent market volatility and heightened enforcement scrutiny, led to the Securities and Exchange Commission's (the "SEC") recent proposal to establish the Large Trader Reporting System (the "LTRS") under Section 13(h) of the Securities Exchange Act of 1934. In addition to the LTRS, and in an effort to further increase market transparency, the SEC has also recently proposed other trading-related measures focusing on areas such as "flash orders" and "dark pools."[2]

Since the 2008 financial meltdown, both Congress and the SEC have continued to actively explore methods to reform the financial and securities regulatory system, with expected congressional action seemingly imminent. And, just this past week, SEC Chairman Mary Schapiro provided congressional testimony regarding possible causes and responses for Wall Street's recent trading scare, in which the Dow Jones Industrial Average experienced a midday plunge of nearly 1,000 points.[3] In light of this recent severe market disruption, the SEC's impetus and resolve for establishing the LTRS and other measures has very likely only increased. According to the SEC, the LTRS will enhance its ability to identify large traders, quickly obtain trading information regarding these substantial market participants, and analyze their trading activity.[4] From an enforcement perspective, the proposed rule will provide the SEC with more prompt access to trading information for investigating potentially abusive, manipulative, or otherwise illegal trading activity such as insider trading and market manipulation.

Background

As part of its regulatory and enforcement efforts, the SEC currently obtains securities transaction information from registered broker-dealers through the Electronic Blue Sheet ("EBS") system. The SEC uses data obtained from this system for two primary reasons: (1) investigating possible federal securities law violations; and (2) reconstructing the market.[5] Enhancements made to the EBS system nearly 10 years ago, however, have proven inadequate for the SEC to monitor large and high frequency trading in the present day securities market. More specifically, because the EBS system

does not promptly collect large volumes of data, the SEC believes that it is "insufficient for large-scale investigations and market reconstructions involving numerous stocks during peak trading volume periods."[6] Hence, the SEC has proposed the LTRS.

The Large Trader Reporting System

Under the LTRS, large traders would be required to identify themselves to the SEC by submitting an initial Form 13H to the Commission. After this initial filing, each large trader would receive from the SEC a unique large trader identification number ("LTID"), which the SEC plans to use for identifying and analyzing large trader activity. The large trader would then be required to disclose the LTID to each of its registered broker-dealers and to identify all of the accounts held by that broker-dealer through which it trades. Subsequent to the initial filing, large traders would be required to submit a Form 13H to the SEC annually, and for interim, inactive status, reactivated status, or termination filings.[7]

The proposed rule also imposes certain recordkeeping and reporting requirements on registered broker-dealers and requires them to provide trading information to the SEC quickly concerning large traders upon request. Although the data requisites for broker-dealers under the proposed LTRS remain similar to the EBS system, two significant differences exist under the LTRS: (1) broker-dealers will be required to maintain and report the LTID and transaction times to the SEC; and (2) broker-dealers will have to provide transaction data to the SEC the morning after the day on which the large trader effected transactions. The SEC believes that such prompt access to this trading activity will greatly assist its investigative efforts into potentially manipulative or illegal trading activity. If this rule is ultimately adopted, large traders and brokerage firms should expect increased pressure and demands to provide trading information to the SEC's enforcement staff promptly.

In order to promote compliance with the LTRS, broker-dealers will also be required to monitor transactions by customers at their brokerage firm to determine if they qualify as "large traders." Under the proposed rule, a "large trader" will generally include a firm or individual whose transactions in exchange-listed securities equal or exceed either: (1) two million shares or $20 million during any calendar day; or (2) 20 million shares or $200 million during any calendar month.[8] For firms, the primary focus of the identification requirement will be on the parent company rather than on the controlling owners of the parent company. And, a parent holding company would generally be required to file on behalf of itself and each of its large trader subsidiaries.[9]

Flash Orders

In addition to the LTRS, the SEC has proposed certain other trading-related measures in an effort to further increase market transparency of stock prices and liquidity. Specifically, it proposed a rule that would effectively prohibit all markets from displaying flash orders, which are orders communicated to certain market participants that are either immediately executed or immediately withdrawn after being communicated.[10] Reasons given by the SEC for abolishing "flash orders" include that (1) such orders are no longer necessary or appropriate in today's highly automated trading environment; (2) flashing orders outside the consolidated quotation data stream can result in a two-tiered market where the public does not have the same access to information regarding the best available prices that other market participants have; (3) they may detract from the incentives for market participants to display their trading interest publicly and thereby harm quote competition among markets; and (4) they may deprive those who display their trading interest at the best prices from receiving speedy execution at that price.[11]

Dark Pools

The SEC has also proposed a rule concerning "dark pools," which have been generally defined as alternative or "electronic trading systems that do not display quotes in the consolidated quotation stream," or rather private trading systems that do not publicly display quotes.[12] The largest dark pools are sponsored by securities firms for executing customer and proprietary orders.[13] Dark pools have recently become a hot topic for the SEC because their percentage of total listed trading volume in the U.S. has been measured at nearly 9%.[14] This, according to SEC Chairman Schapiro, raises significant market structure policy concerns.[15] Under the proposed rule, the SEC would generally require that information about an investor's trading interest be made publicly available, instead of being available only to a select group operating within the dark pool.[16]

Conclusion

The three measures discussed above essentially focus on increasing market information and transparency. Therefore, although these proposed rules are still under consideration, it is quite clear that the SEC plans to increase its regulatory and enforcement presence in the trading markets, particularly with respect to large traders. Moreover, regardless of the final form or outcome of these trading-related measures, regulated entities and substantial market participants can very likely continue to expect increased regulation and scrutiny from the federal government.

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[1] *See* SEC Rel. No. 34-61908, Large Trader Reporting System (Proposed rule), *available at* http://www.sec.gov/rules/proposed/2010/34-61908.pdf.

[2] *See* Testimony of Mary L. Schapiro Before the Subcommittee on Financial Services and General Government (Apr. 28, 2010), *available at* http://www.sec.gov/news/testimony/2010/ts042810mls.htm.

[3] *See* Testimony of Mary L. Schapiro Concerning the Severe Market Disruption on May 6, 2010 Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the U.S. House of Representatives Committee on Financial Services (May 11, 2010), *available at* http://www.sec.gov/news/testimony/2010/ts051110mls.htm.

[4] *See* SEC Press Release, *SEC Proposes Large Trader Reporting System* (Apr. 14, 2010), *available at* http://www.sec.gov/news/press/2010/2010-55.htm.

[5] *See supra* note 1.

[6] *Id.*

[7] *Id.*

[8] *See supra* note 4.

[9] *See supra* note 1.

[10] *See* Testimony Concerning Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues (Oct. 28, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts102809jab.htm.

[11] *See* Speech by SEC Staff: Remarks at the Trader Forum 2009 Fall Workshop: Securities Markets and Regulatory Reform (Oct. 8, 2009), *available at* http://www.sec.gov/news/speech/2009/spch100809jab.htm.

[12] *Id.*

[13] *See* SEC Press Release, *SEC Issues Proposals to Shed Greater Light on Dark Pools* (Oct. 21, 2009), *available at* http://www.sec.gov/news/press/2009/2009-223.htm.

[14] *See supra* note 10.

[15] *Id.*

[16] *See supra* note 2.

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