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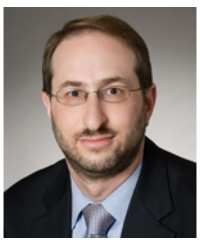
High-Frequency Trading: New Developments in Regulatory Enforcement



BY JASON GOTTLIEB AND ALYSSA ASTIZ

The publication and widespread publicity of Michael Lewis's best-seller on high-frequency trading, "Flash Boys: A Wall Street Revolt," has led many on Wall Street and beyond to ask: what are the regulators doing about high-frequency trading?

After years of debate regarding the costs and benefits of high-frequency trading, regulatory enforcement is on the horizon.

In a recent speech, New York Attorney General Eric Schneiderman announced that his office has launched a broad investigation into whether the current market structure allows unfair advantages to high-frequency traders.[1] Schneiderman called for the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) to "step up" regarding high-frequency trading, an activity he has styled "Insider Trading 2.0." [2]

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The Wall Street Journal reported that the FBI has been conducting a year-long investigation into whether high-speed trading violates insider trading laws.[3]

For its part, the SEC released its literature review of various high-frequency trading studies on March 18,[4] and SEC Chair Mary Jo White has said that the Commission also has several other active investigations into potential wrongdoing by high-frequency trading.[5] These investigations follow actions against the New York Stock Exchange and several purported market manipulators showing some enforcement bite.

In February the CFTC wrapped up the comment period for its sweeping Concept Release on Risk Controls

[1] Keri Geiger & Sam Mamudi, *High-Speed Trading Faces New York Probe Into Fairness*, BLOOMBERG (March 18, 2014), http://www.bloomberg.com/news/2014-03-18/high-speed-trading-said-to-face-n-y-probe-into-fairness.html.

[2] Eric Schneiderman, New York State Office of the Attorney General, Remarks on High-Frequency Trading & Insider Trading 2.0 at the New York Law School Panel on Insider Trading 2.0 – A New Initiative to Crack Down on Predatory Practices (Mar. 18, 2014), *available at* http://www.ag.ny.gov/pdfs/HFT_and_market_structure.pdf [hereinafter Schneiderman Speech].

[3] Scott Patterson & Michael Rothfeld, FBI Investigations High-Speed Trading, WSJ.COM, Mar. 31, 2014, http://online.wsj.com/news/article_email/SB10001424052702304886904579473874181722310-lMyQjAxMTA0MDAwMTEwNDEyWj.

[4] Staff of the Division of Trading & Markets, SEC, Equity Market Structure Literature Review (Mar. 18, 2014), http://www.sec.gov/marketstructure/research/hft_lit_review_march_2014.pdf.

[5] Sara Lynch & Karen Freifeld, SEC chair discusses probes into high-speed trading, REUTERS, Apr. 1, 2014, http://www.reuters.com/article/2014/04/01/us-congress-sec-highspeed-idUSBREA301RC20140401.

and System Safeguards for Automated Trading Environments, providing the CFTC with responses to over a hundred questions about high-frequency trading, including risk control and testing requirements for algorithmic strategies.[6] The agency is currently considering these comments, and considering action.[7]

Congress is putting high-frequency trading under the microscope as well. On Feb. 28, 2014, the House Financial Services Committee began an investigation into Regulation NMS, one oft-cited cause of the proliferation of high-frequency trading.

A Closer Look at Reg NMS. Reg NMS has four key components:

(1) the ''order protection rule'' which requires exchanges to establish and enforce procedures designed to prevent trade execution at prices inferior to protected quotations displayed by other trading centers;[8]

(2) the ''access rule'' which requires fair and nondiscriminatory access to quotations, establishes a limit on access fees, and requires exchanges to adopt and enforce rules prohibiting display of quotations that lock or cross quotations;[9]

(3) the ''sub-penny rule'' establishes a quote minimum price variation of one penny for securities greater than one dollar;[10] and

(4) the ''market data rules'' which amend the requirements of the joint industry plans for disseminating market information.[11]

Reg NMS was introduced in 2004 as a way to modernize and strengthen the existing national market system, promote fair competition, and provide greater investor protection.[12] Following the introduction, the SEC was flooded with nearly 1,700 comment letters. Critics of the Regulation warned of its unintended consequences, including decreased price and quantity discovery; increased gaming opportunities; increased market fragmentation; and increased volatility.[13]

The Regulation was narrowly approved by a vote of 3 to 2. In dissent, Commissioners Paul Atkins and Cynthia Glassman were highly critical of Reg NMS, arguing that the ''complexity of the Rule structure invites exploitation that may create unforeseen market distortions'' and describing the rule as ''anti-competitive.''[14] Commissioners Atkins and Glassman also went as far to allege that the majority, Chairman William Donaldson and Commissioners Roel Campos and Harvey Goldschmid, ''cherry-picked'' statistics from the SEC's Office of Economic Analysis to justify their position on the Rule.[15]

Reg NMS, and specifically the ''order protection rule,'' helped drive the growth of high-frequency trading and the intense speed of the modern markets.[16] In effect, the rule requires that exchanges and traders accept only the most competitive bid or offer prices posted at any U.S. trading venue that displays price quotes,[17] which in turn requires exchanges and traders to scan all of the various available markets before executing a trade. These requirements have led to an arms race for technologies that permit traders to search the markets faster than competitors, to enable them to route orders as close to instantly as possible to the exchange where the price is best.[18]

Attorney General Schneiderman's March 18 speech suggests that Reg NMS may not only be a target of regulatory change, but is also on the enforcement agenda. Schneiderman opined that the current market structure ''rewards high-frequency traders who continuously flood the market with orders—emphasizing speed over price.''[19] In his office's efforts to ''shine a light on unseemly practices in the markets . . . that cater to high-frequency traders at the expense of other investors,''[20] scrutiny of high-frequency trading practices that relate to Reg NMS may lead to legal action. In recent months, SEC Chair Mary Jo White and the other SEC Commissioners also have spoken about the need to examine the effects of high-frequency trading and Reg NMS.

The CFTC's Continued Focus on High-Frequency Trading. The CFTC issued its Concept Release in September 2013, presenting 124 questions for comment focused on four principal areas in the context of automated and high-frequency trading: (1) pre-trade risk controls; (2) post-trade reports and other post-trade measures; (3) system safeguards; and (4) additional risk controls. The agency received dozens of comments from trading firms, academics, trade organizations, and individual investors, reflecting diverse views about the legality of certain high-frequency algorithmic trading strategies, the need for a definition of high-frequency trading, and prescriptive versus principals-based risk controls.

Better Markets, an outspoken nonprofit that actively advocates for financial reform, was especially critical of high-frequency trading in its comment letter. The letter describes the practice of pinging, submitting and rapidly canceling an order to gauge market interest that is

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[6] CFTC Concept Release on Risk Controls and System Safeguards for Automated Trading, 78 Fed. Reg. 56,542 (Sept. 12, 2013).

[7] Public Meeting of the Technology Advisory Committee (Feb. 10, 2014), *available at* http://www.cftc.gov/PressRoom/Events/opaevent_tacmeeting021014 [hereinafter TAC Meeting].

[8] Rule 611 (17 CFR 242.611).

[9] Rule 610 (17 CFR 242.610).

[10] Rule 612 (17 CFR 242.605).

[11] Rules 600, 601, and 603 (17 CFR 242.600, 601, and 603).

[12] Regulation NMS, 69 Fed. Reg. 11126 (proposed Feb. 24, 2004).

[13] Regulation NMS: Final Rules and Amendments to Joint Industry Plans, 70 Fed. Reg. 37,496, 37,640 (June 29, 2005).

[14] *Id.* at 37,639.

[15] *Id.* at 37,635.

[16] Jacob Bunge, *A Suspect Emerges in Stock-Trade Hiccups: Regulation NMS*, WSJ.COM, Jan. 27, 2014, http://online.wsj.com/news/articles/SB10001424052702303281504579219962494432336. The Regulation, specifically its ''market data rules,'' was also the subject of the SEC's historic regulatory action against the New York Stock Exchange (NYSE) in September 2012, its first financial penalty ever against an exchange, for violating Reg NMS by providing certain traders timing advantages through access to the NYSE's proprietary data feeds. *See* Eliot Lauer, Jason Gottlieb & Alyssa Astiz, *High Frequency Trading: Are the Exchanges the Next Targets?*, BLOOMBERG BNA SEC. REG. & L. REP. (June 3, 2013).

[17] Bunge, *supra* note 16.

[18] *Id.*

[19] Schneiderman Speech, *supra* note 2.

[20] *Id.*

often employed by high-frequency traders,[21] as a "technique akin to using sonar to locate a whale underwater to harpoon it" and "a clear analog to traditional concepts of front-running."[22] Better Markets' comments also argue that, in order to prevent front-running by high-frequency traders "it is crucial that regulators have access to HFT algorithm source code, rather than facing the impossible task of reconstructing manipulative algorithms from market data alone."[23]

On Feb. 10, prior to the end of the comment period, the CFTC's Technology Advisory Committee (TAC) held a meeting to discuss the Concept Release where it received statements from representatives from trading firms, academics, and industry associations. Like the comment letters, the statements reflected the ongoing debate about high-frequency trading, with some touting its benefits for liquidity, and some calling high-frequency traders "technological arms race dealers."[24] Christopher Concannon, executive vice president and partner with Virtu Financial, explained that there is a general consensus that some additional risk controls are necessary in today's fast modern markets.[25] These controls may include measures such as maximum order size limitations, maximum execution rates, trade cancellation policies, and minimum resting periods.

Conclusion. The SEC, CFTC, and law enforcement authorities have long been talking about tackling the problem of high-frequency trading, but so far, actual enforcement has not been as frequent as the amount of discussion might suggest. Based on recent events, however, it appears that enforcement authorities are ramping up their efforts to rein in high-frequency trading, a move that will likely lead to regulatory changes, as well as action against high-frequency traders that engage in what regulators may term predatory practices.

[21] Eliot Lauer, Jason Gottlieb & Alyssa Astiz, *Stay Afloat in the New Wave of High-Frequency Trading Actions*, N.Y. L.J., Feb. 25, 2013, *available at* http://www.newyorklawjournal.com/id=1202589088509.

[22] Comment Letter from Dennis Kelleher, Caitlin Kline, and David Frenk, Better Markets, to Melissa Jurgens, CFTC (Dec. 11, 2013), *available at* http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1459.

[23] *Id.* at 4.

[24] TAC Meeting, *supra* note 7.

[25] *Id.*