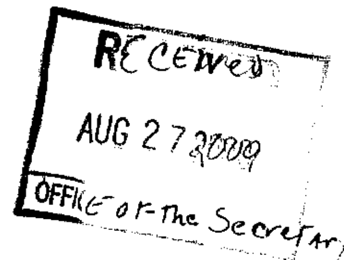

Ms. Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Flash Orders and Trades and Server Co-Location

4-589

To the Commission:

Atherton Lane Advisers, LLC ("Atherton Lane") is an SEC registered investment adviser that offers comprehensive wealth management and investment counseling services to private clients. We are writing to urge the Commission to promptly create rules which regulate or ban the trading practice known as flash orders and the practice of server co-location.

We are concerned that flash orders and trades offer trading advantages to some market participants. As stated by Senator Schumer in a letter dated July 24, it appears that the practice of flash trading allows certain traders to obtain order flow information for computer-based trading before the information is routed to the broader public market and creates a "two-tiered system where a privileged group of insiders receives preferential treatment, depriving others of a fair price for their transactions." While proponents of such trading practices may argue that the practice provides liquidity, increases the speed of execution and helps traders get better prices, we believe that the real and perceived unfairness of the practice described above far outweighs its purported benefits.

As with flash orders and trades, it appears that the establishment of a trader's computer servers on or near the floors of market centers, or even within the firewalls of market centers (server co-location), offers an advantage to traders (e.g., hedge funds) who use it relative to those who do not. Some have argued that through server co-location, high frequency traders may get ahead of orders by institutional and retail traders.

Finally, these practices may impact our best execution obligations to our clients. We typically send trades to broker-dealers who in turn send trades to market centers. If some, but not all, market centers offer flash orders and/or server co-location, our decisions regarding best execution might be affected.

We respectfully request that the Commission promptly create rules addressing flash orders and server co-location. At that time, we will take the opportunity to comment on the proposed regulations.

Sincerely,

William E. McDonnell, Jr.
Chief Compliance Officer

3000 Sand Hill Road, Building 1 - Suite 170 Menlo Park, California, 94025-7162 phone 650.233.1200 fax 650.233.1201 athertonlane.com

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Co-Location Takeaways From The NYSE Settlement

Law360, New York (July 07, 2014, 10:37 AM ET) --

Adam J. Wasserman

The U.S. Securities and Exchange Commission on May 1, 2014, announced a settlement with the New York Stock Exchange LLC and certain of its affiliates (collectively, the NYSE), addressing a variety of practices — including informational disparities and the current hot-button topic of co-location.[1] In this latest settlement concerning electronic trading and the dissemination of market data,[2] the NYSE agreed, without admitting or denying the SEC's findings, to settle charges relating to a wide variety of historic conduct that largely took place between 2005 and 2011. As part of the settlement, the NYSE consented to a $4.5 million civil monetary penalty and the retention of a compliance consultant.

The settlement marks the first enforcement action by the SEC implicating practices employed by electronic and high-frequency trading (HFT) firms since the publication of Michael Lewis' book, "Flash Boys" — in which Lewis argues that HFT unfairly exploits informational disparities. The settlement also follows criticism by the New York attorney general (NYAG) of co-location arrangements at securities exchanges, as well as calls by the NYAG for the SEC and other regulators to focus their attention on HFT issues.[3]

This article discusses the three charges in the commission's order that specifically address informational disparities, namely: (1) the provision of co-location services to certain customers prior to September 2010, pursuant to terms that were individually negotiated with private firms and not submitted for SEC approval; (2) the lack of procedures to prevent the misuse of nondisplayed liquidity in order books for exchange error account trading; and (3) the early distribution of order imbalance information to floor brokers — a practice that was not fully disclosed to the public.[4]

This article also explores how the settlement is consistent with prior statements and practices by the SEC staff concerning market structure issues.

Description of the Settlement

Allegations that Prior to September 2010, NYSE Provided Co-Location Services Without SEC Approval

"Co-location" is a service offered by securities exchanges that enables market participants to obtain

faster access to exchange information, often by permitting trading firms to place servers at exchanges' data centers in order to have direct access to trading data. Although a market center is not permitted to provide data to private linkages prior to the time that such data is reported to the securities information processor (SIP) for public dissemination, direct data feeds allow firms to receive and act on information microseconds prior to the time the information is published by the public data feed.

Previously, in its 2010 concept release on equity market structure, the SEC acknowledged the role of co-location at registered exchanges:

The Commission believes that the co-location services offered by registered exchanges are subject to the Exchange Act. Exchanges that intend to offer co-location services must file proposed rule changes and receive approval of such rule changes in advance of offering the services to customers. The terms of co-location services must not be unfairly discriminatory, and the fees must be equitably allocated and reasonable.[5]

Despite the criticism of co-location by Michael Lewis and the NYAG, the settlement confirms that the commission has approved, and now regulates, the provision of co-location services as "a material aspect of the operation of the facilities of a national securities exchange." In the settlement, however, the SEC focused upon the contention that, from at least 2006 through September 2010, the NYSE offered co-location services without filing a proposed rule with the commission and that, during this time period, the fees charged by the NYSE for these services were individually negotiated and not uniform for all customers.

While, in response to a recommendation by the SEC's Office of Compliance Inspections and Examinations (OCIE), the NYSE and certain affiliates submitted rule proposals to the SEC in 2009 governing co-location services, the commission staff expressed concerns that the proposed rule would allow for pricing disparities between new co-location customers (who would be subject to a standard rate) and old co-location customers (who would be charged their lower previously negotiated rates).

Under Exchange Act Section 6(b)(5), the rules of an exchange may not be designed to permit, among other things, unfair discrimination among customers, issuers, brokers or dealers. The SEC staff was specifically concerned that individually negotiated co-location fees could lead to questions as to whether the fees were being equitably allocated among customers. However, it was not until September 2010 that the NYSE effectuated an exchange rule that standardized co-location fees for all customers.[6]

According to the SEC, the NYSE's co-location practices until September 2010 violated Section 19(b)(1) of the Exchange Act, which requires that securities exchanges file proposed rule changes with the SEC. The settlement acknowledges that, in the initial years following the adoption of Regulation NMS, some firms may have had individually negotiated co-location agreements — a practice that is criticized in Flash Boys. At the same time, however, the commission has underscored the fact that this is no longer tolerated and that policy issues, like co-location, have been on the SEC's radar and subject to regulation by the commission for the past several years.

Allegations That ArcaSec Failed to Implement Policies and Procedures to Prevent the Misuse of Material Nonpublic Information in Connection with Its Error Account

The SEC noted that ArcaSec, which served as a routing broker for various NYSE affiliates since 2005, used an error account to unwind securities positions that the NYSE held as a result of "computer system

malfunctions or outages, unmatched orders, errors from routing to other exchanges, or accommodations." The ArcaSec error account was traded by members of the Arca Trade Operations Desk (TOD).

The SEC alleged that, between 2005 and October 2010, TOD employees could run both their normal trading program and a separate Global Trade Manager (GTM) program that showed the NYSE's "entire depth of book, including nondisplayed liquidity." According to the SEC, this permitted the traders to "view all nondisplayed buy and sell orders for each listed security," enabling "them to anticipate possible shifts in a security's price from pending nondisplayed orders."

The SEC claimed that the GTM data, which was supposed to be used solely for tracking orders and facilitating efficient trading, constituted material nonpublic information and that, prior to October 2010, ArcaSec lacked policies and procedures to ensure that TOD employees were not using the GTM data in connection with error account trading. While the SEC notified ArcaSec of this deficiency in February 2010, the SEC alleged that ArcaSec did not sufficiently address this issue until October 2010.[7]

The SEC concluded that this conduct violated Section 15(g) of the Exchange Act, which requires broker-dealers to establish and implement policies and procedures to prevent the misuse of material nonpublic information. Specifically, the SEC found that ArcaSec: had no written policies or procedures specifically addressing the access to nondisplayed liquidity information by TOD personnel liquidating securities positions in the ArcaSec error account; lacked systems that would have prevented TOD personnel from accessing such information; and lacked policies or procedures for surveilling whether the TOD personnel acting on its behalf were accessing material nonpublic information while trading in the error account.

The SEC noted that "the mere establishment of policies and procedures alone is not sufficient to prevent the misuse of material nonpublic information. It also is necessary to implement measures to monitor compliance with and enforcement of those policies and procedures." The action by the SEC in this regard emphasizes the fact that markets must have and effectively implement procedures to prevent the misuse of customer order information.[8]

Allegations That NYSE Distributed Closing Order Imbalance Information in Violation of Exchange Rules

Another violation addressed in the settlement involved an NYSE rule that allowed floor brokers to receive a subscription to an electronic feed of closing order imbalance information each day at 3:40 p.m.[9] Seven months following the May 2008 effective date of the NYSE's rule, the NYSE revised its systems to provide closing order imbalance information to its operations staff at 2 p.m. However, when these systems were revised with respect to the operations staff, this feed was mistakenly delivered to floor brokers at 2 p.m. as well.

The SEC stated that, despite knowing that the floor brokers were receiving this information prior to 3:40 pm, the NYSE continued its 2 p.m. dissemination of the information to floor brokers until May 2010 — even after the SEC had informed the NYSE in March 2010 that this earlier dissemination violated the NYSE's existing rules and required a rule change.

According to the SEC, the floor brokers obtained an informational advantage about "which other market participants and the public were not aware." The SEC found that this conduct violated Exchange Act Section 19(g)(1), which requires an exchange to comply with its own rules. Thus, the settlement highlights the fact that exchange rules previously approved by the SEC, which may have been relied on by other market participants, must be followed.

Selected Observations Relating to the Settlement

It is clear that the settlement relates to practices that occurred well before Michael Lewis and the NYAG raised their recent concerns about market integrity. Indeed, much of the alleged conduct that formed the basis for the settlement occurred between 2005 and 2011. The settlement is confirmation of SEC Chairwoman Mary Jo White's comments indicating that the commission has a number of ongoing investigations regarding "market integrity and structure issues, including high-frequency traders," which have been under way for "quite some time."[10]

The settlement illustrates both that the SEC has been aware of the potential for informational disadvantages resulting from technology following the adoption of Regulation NMS and that the SEC has worked since at least 2009 to address certain co-location practices that it deemed unfair. The settlement also illustrates that certain of the practices complained of by Lewis have not occurred at the NYSE since 2010.

While co-location remains a topic of policy discussion, the SEC's focus on rule filing procedures, rather than the practice of co-location itself, is a reminder that the commission has approved of co-location. This is in contrast to the position of the NYAG, who has attacked the practice — claiming that "one of the worst problems" his office had discovered was "the tendency for our markets and institutions to start catering to high-frequency traders, and becoming enablers of this particularly dangerous type of trading."[11]

While the NYAG has urged the SEC and other regulators to address what he believes to be "unseemly practices in the markets," the commission has been focusing on the marketwide impact of electronic and HFT issues for many years now, including some of the specific practices complained about by Lewis and the NYAG.

White has stated that she does not wish to rush to judgment when making changes to complex market rules, but rather "want[s] to do a soup-to-nuts review," starting with the presumption that "the markets are not rigged" — which also involves weighing any positive effect that HFT has on the markets.[12] She testified in recent congressional hearings that any rule changes in this area will be "supported by data as ... [the SEC surveys] the entire market, rather than focusing on speed traders."[13]

And, on June 5, 2014, White announced that the SEC will be advancing initiatives addressing several sets of issues, including market instability, high-frequency trading (and specifically the use of destabilizing trading strategies that exacerbate price volatility), fragmentation of the trading markets, broker conflicts, the building of quality markets for smaller issuers.[14]

Although the settlement focuses on the NYSE, it touches upon issues that are relevant to other market participants as well. During her congressional testimony last month, White commented that the commission had been intensifying its review of off-exchange trading venues used by high-frequency traders.[15] Other nonexchange trading centers — while not subject to the same degree of SEC oversight as exchanges — also have fair access requirements under Regulation ATS, are subject to Rule 603 of Regulation NMS (which addresses the provision of trade information through direct data feeds), and must make sure that they operate in the manner disclosed to participants.[16] The settlement is a reminder that alternative trading platforms also must remain vigilant to ensure that they adhere to such requirements.

Finally, it is evident in a number of the SEC's charges against the NYSE that technology presents its own unique set of risks, and that lack of coordination between technology developers and the legal and compliance staff can be problematic. Advances in technology require time, attention and understanding by compliance staff to prevent mistakes that may result in regulatory violations.

Conclusion

Regulatory scrutiny of HFT and market structure issues concerning informational advantages is likely to continue. Thus, while the SEC's settlement with the NYSE is the first post-"Flash Boys" action regarding market integrity issues, in light of the attention placed on HFT and electronic trading, it is not likely to be the last.

—By Adam J. Wasserman, Edward L. Pittman and Robert J. Rhatigan, Dechert LLP

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[1] The settlement was announced in an order In the Matter of New York Stock Exchange LLC, NYSE Arca, Inc., NYSE MKT LLC, f/k/a/ NYSE Amex LLC, and Archipelago Securities LLC, Securities Exchange Act Rel. No. 72065 (May 1, 2014).

[2] In 2012, the NYSE was subject to the first financial fine against an exchange — in the amount of $5 million — based on SEC charges that the NYSE had provided certain exchange customers with access to market data before such data was released to the consolidated feeds. In the Matter of New York Stock Exchange LLC, andNYSE Euronext, Securities Exchange Act Rel. No.67857 (Sept. 14, 2012). Rule 603(a) of Regulation NMS prohibits market centers, including exchanges, from releasing data relating to quotes and trades through private proprietary feeds before sending such data for inclusion in the consolidated feeds.

[3] Eric T. Schneiderman, N.Y. Att'y Gen., Remarks on High-Frequency Trading & Insider Trading 2.0, New York Law School Panel on "Insider Trading 2.0 – A New Initiative to Crack Down on Predatory Practices" (Mar. 18, 2014) (Schneiderman Remarks).

[4] The SEC also accused the NYSE of: (1) conducting error account trading without effective exchange rules; (2) violating a net capital rule in connection with a January 2010 incident involving a trading systems testing error (that resulted from connecting a testing tool to a live environment); (3) failing to operate the New York Block Exchange (an electronic facility focused on large block transactions) in accordance with exchange rules; (4) failing to execute mid-point passive liquidity orders in accordance with exchange rules; and (5) accepting mid-point passive liquidity orders with subpenny limits in violation of Regulation NMS.

[5] SEC Concept Release on Equity Market Structure, Securities Exchange Act Rel. No. 61358, January 2010.

[6] This rule was adopted in connection with the relocation of all customers to a single new data center.

[7] Additionally, the SEC found that the NYSE used the error account for years without submitting a rule regarding the issue to the SEC, and that despite OCIE's direction in 2010 that a rule be submitted, the NYSE continued to use the error account through 2011 — even after NYSE compliance officials prohibited them from doing so.

[8] Section 15(g) applies to all brokers, including non-exchange market centers registered with the commission under Regulation ATS (e.g., "dark pools").

[9] This information reflects the imbalance between the interest to buy and the interest to sell a security.

[10] Ackerman, A., SEC Investigations into High-Frequency Trading under Way, WSJ.com (April 1, 2014). It is notable also that the settlement begins by focusing on matters of market integrity. In particular, the settlement recites the requirements that: an exchange's rules must be designed to assure the fairness of its markets; an exchange must operate in compliance with its own rules, so that its members and others will understand the terms and conditions under which trading will be conducted; exchange rules must be designed to prevent fraudulent and manipulative acts; and the rules must not be designed to permit, among other things, unfair discrimination.

[11] Schneiderman Remarks.

[12] Michaels, D., et al, Slow Cop, Fast Beat: SEC Takes Its Time on High-Frequency Trading Rules, Bloomberg Businessweek (April. 10, 2014). This does not mean that the SEC is not investigating certain of the accusations levied by critics. For example, it recently was reported that the commission has issued subpoenas to brokerage firms "as part of a probe into how retail customers' orders are routed, executed, and filled ...." Lynch D. and Flitter, E., Exclusive: SEC probing brokerages of retail orders — sources, Reuters (May 6, 2014).

[13] Michaels, D., supra note 12.

[14] See, Speech on "Enhancing Our Equity Market Structure" by Mary Jo White, SEC Chair, Sandler O'Neill & Partners, LP Global Exchange and Brokerage Conference (June 5, 2014).

[15] See, Mary Jo White, Testimony before the Committee on Financial Services (Apr. 29 2014).

[16] Similar "fair access" standards are applied to nonexchange market centers registered with the commission under Rule 301 of Regulation ATS, if such centers exceed volume certain thresholds. Under the rule, access must be based on objective standards and cannot be individually negotiated. See In the Matter of INET ATS, Inc., Securities Exchange Act Release No. 53631 (Apr. 12, 2006). Regulation ATS also requires that a market center have procedures and safeguards to ensure the confidential treatment of trading information. See In the Matter of eBX LLC, Securities Exchange Act Release No. 67969 (Oct. 3, 2012). See also, generally, Staff Summary Report on Examinations of Information Barriers: Broker-Dealer Practices under Section 15(g) of the Securities Exchange Act of 1934, by the staff of the Office of Compliance Inspections and Examinations, SEC (Sept. 27, 2012) and FINRA Rule 5270 Front Running Policy (which includes exceptions for automated trading and where information barriers are present). Similarly, while the policies of ATS are not required to be publicly disclosed, an ATS' policies and

contractual provisions in subscriber agreements must be followed. See, e.g., In the Matter of Pipeline Trading Systems LLC et. al., Securities Exchange Act Release No. 65609 (Oct. 24, 2011).

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