

Execution Enforcement Actions Escalate

Schulte Roth's broker-dealer regulatory & enforcement lawyers

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Leading law firm Schulte Roth & Zabel recently announced a major expansion with the addition of a group of broker-dealer attorneys. Resident in the firm's New York office, Julian Rainero and Craig S. Warkol joined as partners and co-chairs of Schulte's Broker-Dealer Regulatory & Enforcement Group, and Douglas I. Koff joined as partner. Also joining were special counsel David S. Sieradzki in Washington, D.C., as well as Kelly Koscuiska and Evan F. Barnes in New York. Their counsel is highly sought-after, especially as broker-dealers face heightened government scrutiny. *The Hedge Fund Journal* spoke to the partners about the growing demand for advice on broker-dealer matters including complex market structure and execution issues.

Rainero stated he "always wanted to be part of a preeminent investment management practice and Schulte is the best in the world." He was particularly attracted to Schulte due to its expertise in OTC derivatives, which he says "touch a lot of related areas." The broker-dealer partners work closely with clients to ensure compliance with the requirements of the SEC, the Federal Reserve Board, FINRA and other securities industry SROs. The lawyers discussed several market microstructure issues with *THFJ*.

ATS transparency

Regulators have brought enforcement actions around alternative trading systems (ATSs), including 'dark pools', and routing issues. Since 2011, the SEC has brought at least eight actions against ATS operators, but up until 2015, the fines were in single digit millions. The SEC and other regulators have, in early 2016, levied the largest ever fines – tens of millions – on ATS operators. The regulators have alleged that conflicts of interest arose when order information was shared with affiliated entities, or other market participants.

Warkol "does not think that there was necessarily any bad intent on the part of bank operators of ATSs." Indeed, most of the

actions did not demand any disgorgement of purported profits associated with rule breaches. Rather, Rainero argues that "most of the regulators' complaints relate mainly to the accuracy and comprehensiveness of product descriptions, in areas such as order type descriptions and manner of operation." The issues can be relatively straightforward in some cases and rather technical in others. Warkol claims one case "is essentially an accuracy of marketing claim in terms of how ATSs categorise participants and describe anti-predatory features and does not have any particular dark pool aspect to it." In contrast actions brought against dark pools tend to be much more technical.

One lesson is to regularly update communications. "Though most ATSs are not subject to the SEC's Fair Access Rule the SEC takes the view that they should be clear in describing all services and features," to subscribers, says Rainero.

The SEC's transparency rules for ATSs encourage more disclosure around services, fees, market data, orders and matching logic. This will lead to hundreds of pages of disclosures, some participants envisage. FINRA also has an ATS Transparency Initiative. One example of an exercise that ATSs should carry out regularly is "reconciling ATS exhibits with FIX Protocol specifications that are sent to each client," Rainero advises.

Some individuals involved in designing and developing algorithms subject to regulatory actions were not registered with regulators. In the future, certain technology staff will need to be registered – even if they have no direct interaction with customers. (Schulte lawyers recently contributed an article to *THFJ* on this new requirement.) "This sends a signal that the design and implementation of systems has legal consequences," points out Koff, and in principle he supports this general thrust of registering more staff, even though the benefits of registration are symbolic or message-based

rather than effective in ensuring personnel have the requisite skills to perform their functions. But he does think "it is difficult to draw a line about what level of involvement technology staff need to become registered."

If Warkol sees the rationale for registering more coders, programmers and other techies, he suggests that regulators' stridency in recent actions might be disproportionate in some cases, for two reasons. The cases often related to "peripheral services or features that may only be used by a small percentage of users, who might not care about any misrepresentation of a service they were not utilising," he points out.

Perhaps, more importantly, sell-side broker dealers are the primary subscribers to ATSs by volume and Koff is of the opinion that "sophisticated professional sell-side traders are capable of analysing opportunities, and the nature and character of liquidity, on their own."

Koff admits that some buy-side users of ATSs might be less sophisticated and thinks that they are more germane to the SEC's objectives.

Subjective and unclear rules

Arguably, trade routing issues are of a grave concern only if it can be proved that an investor has suffered a loss as a consequence of sub-optimal execution. Buy-side firms are only held responsible for execution if it is discretionary, and there have been a few enforcement actions brought by the SEC and FINRA. But demonstrating 'best execution' is becoming a more complicated and subjective process.

In one case, FINRA was able to show that prices obtained were inferior to National Best Bid or Offer (NBBO), but it is not always easy to prove, unequivocally, that best execution was not achieved. "The rules have not changed but the number of factors considered, and the quality of statistics, have increased," explains Warkol.

At the simplest level, buy-side firms may use a variety of different execution benchmarks, such as VWAP, TWAP, Closing Mids or Implementation Shortfall. This means that a trade satisfying one investor's benchmark might not match another investor's bogey. Whether investors prioritise liquidity capture or price improvement also influences whether a particular trade could be deemed as 'best execution'. Therefore, it is not straightforward to assess whether any particular order, or trade routing path, is consistent with the buy-side's firm-specific best execution obligations.

Best execution is only one example of relatively unclear regulations that leave latitude for multiple interpretations. Asserts Rainero, some of the ATS enforcement actions relating to Regulation NMS stem from "a lack of clarity from the SEC on derivatively priced orders." Similarly "there are different opinions on how technologies work between broker-dealers and routers and reasonable people can disagree," argues Rainero.

In some cases he thinks the rules are misguided, so "describing a special order type marketed to high frequency traders (such as certain price-sliding orders) as nefarious is plain silly."

This is another sign of how regulators are pursuing and iterating rules to the nth degree and Warkol sees "an increased focus on the minutiae of market making and HFT liquidity provision." In particular, Warkol notes "the very nitty gritty aspects of Reg NMS, Last Look in the FX world, latency between SIP and direct feeds," in the spotlight.

The rules are complicated because there are often exceptions to general rules, and the SEC's FAQs often need to be regularly modified or updated. This microscopic scrutiny of market microstructure is a new development as "in the past they would not have had the same level of enforcement activity," reflects Koff.

The big picture

Regulators are also tinkering with some rules and using pilots as a possible basis for changes to exchange access fee caps, minimum-increments or even the imposition of a trade-at rule, for instance. Rainero in principle approves of pilots, as he thinks a 'dry run' makes sense. But he is not sure what the exchange access fee cap pilot might demonstrate, and is in fact sceptical about whether a minimum price increment will improve liquidity. "This might lead to more liquidity on a single price point, but not necessarily all liquidity that may be available at all price increments," that would have existed within the minimum price increment, he suggests.

Rainero sees some possibility of changes to limit up/limit down rules. He doubts if the August 2015 'flash crash' will provoke any major regulatory changes, however. He thinks that if flash crashes are one adverse side effect of electronic market making, they are probably the only negative impact. "Everything else, such as execution, spreads and liquidity per price point, are all favourable. The one thing that is not is reducing diversity of human actors, as that means things occur in tandem, as herd behaviour."

So for Rainero, regulators' micromanagement of execution issues misses the big picture in that equity markets have improved to the benefit of investors; but he sees no signs of the SEC cooling-off in terms of its ever deeper interrogation of market data, algorithms, systems and now technology staff. To the contrary, "there is no indication that they cannot carry on digging deeper," Rainero foresees. **THFJ**

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