

Key components of an effective compliance programme for broker-dealers deemed trading centres under Regulation NMS

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implementation for trading centres commences on 9th July, 2007. This paper provides some practical guidance on the key components of an effective compliance programme for broker-dealers that are deemed trading centres under the Rule (ie broker-dealers who execute orders as dealer or who effect agency crosses). The paper focuses on compliance requirements in the areas of supervision, trading operation and record keeping. Although the regulators are likely to use a standard of reasonableness in evaluating compliance efforts in the early stages of the Rule's implementation, it will be important for firms to demonstrate that they have put well-designed procedures in place and are following up on alerts or issues generated by the procedures.

Keywords: Regulation NMS, Order Protection Rule, securities, compliance



ABSTRACT

Securities and Exchange Commission (SEC) Regulation of the National Market System (Regulation NMS) and, in particular, the Order Protection Rule present the most sweeping changes to equity market structure in 30 years. Broker-dealers have been devoting a tremendous amount of resources to ensuring compliance with the Rule once the phase-in

BACKGROUND

Regulation NMS (ie Regulation of the National Market System) was adopted in June 2005 in order to resolve what the Securities and Exchange Commission (SEC) believed were flaws in the structure of the national market system for stocks.¹ This regulation is the most significant equity market rule adopted by

the SEC in 30 years. Perhaps the most important component of Regulation NMS is the Order Protection Rule (also known as the ‘Trade-Through Rule’). This rule, which is found in Rule 611 of Regulation NMS, is designed to establish inter-market protection against trade-throughs for NMS stocks (ie to prevent one trading centre from executing an order at a price that is inferior to the price of a protected quotation — eg a displayed limit order — that is displayed by another trading centre). By strengthening protection of displayed limit orders, the SEC sought to reward market participants for displaying their trading interest, and thereby to promote fairer and more vigorous competition among orders seeking to supply liquidity. It also sought to provide greater assurance that, on an order-by-order basis, investors who submit market orders will receive the best readily available prices for their trades.² Whatever the reasons for the adoption of Regulation NMS, the Rule has engendered, and will continue to engender, profound changes in the structure of the US equity market. The Rule will also create new and enormous compliance responsibilities for many broker-dealers in the USA.

Originally, compliance with the Order Protection Rule was to be phased in starting on 29th June, 2006, for certain NMS stocks, and on 31st August, 2006, for all remaining NMS stocks. These dates were subsequently postponed so that, as of 5th March, 2007, all automated trading centres — both self-regulatory organisation (SRO) trading facilities and alternative display facility (ADF) participants — were required to have their trading systems compliant with Regulation NMS if they intended to qualify their quotations for trade-through protection under Rule 611.³ The pilot stocks phase began on 9th July, 2007, when full industry com-

pliance with Rule 611 for 250 NMS stocks commenced. On this date, all trading centres, including alternative trading systems (ATs), dealers and brokers effecting agency crosses, had to comply with the Order Protection Rule. And on 20th August, 2007, compliance with Rule 611 was required for all remaining NMS stocks (the all stocks phase), with completion of phased-in compliance with Rule 611 to have been achieved by 8th October, 2007.

THE ORDER PROTECTION RULE

Before describing some of the compliance challenges in complying with the Order Protection Rule, it is useful first to go over the contours of the Rule and the compliance requirements embedded in it. Generally, the Order Protection Rule prohibits trade-throughs of protected quotations in NMS stocks by trading centres.⁴ A ‘protected quotation’ is an automated quotation displayed by an automated trading centre that is the best bid and offer (BBO) of an exchange, the BBO of Nasdaq or the BBO of the Financial Industry Regulatory Authority (FINRA). Thus, only a single, accessible best bid and best offer for each of the exchanges (including Nasdaq) and FINRA is protected under the Order Protection Rule. For purposes of Regulation NMS, automated quotations are those displayed and immediately accessible through automatic execution. Automated trading centres⁵ are trading centres that are capable of displaying automated quotations.

The Order Protection Rule requires a trading centre to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading centre of protected quotations in NMS stocks that do not fall within an exception. The

Rule also requires trading centres to survey their markets regularly to ascertain the effectiveness of these policies and procedures, and to take prompt action to remedy any emerging deficiencies. In the Adopting Release, the SEC provided guidance regarding the minimum requirements that are necessary to comply with the Order Protection Rule. According to the SEC, at a minimum:

- a trading centre's policies and procedures must enable the trading centre (and persons responsible for transacting on its market, such as specialists) to monitor, on a real-time basis, the protected quotations displayed by other trading centres, so as to determine the prices at which the trading centre can and cannot execute trades;
- a trading centre's policies and procedures must establish objective standards and parameters governing its use of the Order Protection Rule exceptions (described below); and
- a trading centre's automated order-handling and trading systems must be programmed in accordance with the required policies and procedures;
- a trading centre must take the steps necessary to enforcing its policies and procedures effectively;⁶ and
- a trading centre must regularly assess the continuing effectiveness of its procedures and take prompt action, when needed, to remedy deficiencies. In particular, a trading centre must engage in regular and periodic surveillance in order to determine whether trade-throughs are occurring without an applicable exception, and whether it has failed to implement and maintain policies and procedures that would have reasonably prevented such trade-throughs. A trading centre cannot merely establish policies and procedures that may be reasonable when created,

and then assume that such policies and procedures continue to satisfy the Order Protection Rule.

The exceptions to the Order Protection Rule take into account the mechanics and operational issues that may arise under the Rule, as well as certain trading strategies and order types that are both useful to investors and consistent with the principle of price protection. These exceptions include the following:

- *Trading centre failure, material delay, or malfunction* This exception applies to a transaction should the trading centre displaying the protected quotation that was traded through have been experiencing a failure, material delay, or malfunction of its systems or equipment when the trade-through occurred. The exception for a '*material delay*' gives trading centres a self-help remedy if another trading centre repeatedly fails to provide an immediate response (within one second) to incoming orders attempting to access its quotes. Trading centres must establish specific objective parameters governing their use of this 'self-help' exception as part of their reasonable policies and procedures, and should be prepared to document the legitimacy of invoking a self-help remedy.⁷
- *Flickering quotations* This exception addresses false indications of trade-throughs that are attributable to rapidly moving quotations. A transaction is excepted from the Order Protection Rule if the trading centre displaying the protected quotation that was traded through had displayed, within one second prior to execution of the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction.

Trading centre systems must be programmed to identify and ignore such flickering quotations.

- *Intermarket sweep orders (ISOs)* ISOs are excepted from the Rule. An ISO is a limit order that, when routed to a trading centre, is identified as such and, simultaneously with the routing of such limit order, one or more additional limit orders are routed to execute against the full displayed size of all protected quotations with a superior price at other trading centres. This exception was intended to facilitate the immediate execution of block orders by dealers on behalf of their institutional clients.
- *Benchmark orders* Benchmark orders (ie orders at a price not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made) are excepted from the Rule. One common benchmark order is a volume-weighted average price (VWAP) order.
- *Stopped orders* The execution of certain stopped orders is excepted from the Rule. This exception applies to the execution by a trading centre of a stopped order for which the price of the execution of the order was lower than the national best bid at the time of execution (for a stopped buy order), or higher than the national best offer at the time of execution (for a stopped sell order). To qualify for the exception, the stopped order must be for the account of a customer and the customer must have agreed to the stop price on an order-by-order basis.
- *Additional exceptions* Also excepted from the Order Protection Rule are transactions other than 'regular way' contracts, certain single-price opening, reopening, or closing transactions and certain

transactions executed at a time when protected quotations were crossed.

In addition to the exceptions contained in the Rule, the SEC has subsequently provided exceptions such as the contingent trade exception, the print protection exception and the error trade exception.⁸ The SEC also has issued a series of Frequently Asked Questions (FAQs) on the Order Protection Rule, in which it provides responses to selected interpretive questions that have repeatedly been posed by the industry. As of the date of this paper, the SEC had issued three iterations of the FAQs, the most recent being on 8th June, 2007.

IMPLEMENTATION ISSUES

Since the issuance of the Order Protection Rule, broker-dealers have been devoting a tremendous amount of resources to becoming compliant with the Rule and to ensuring continuing compliance on an ongoing basis once the Rule becomes operational for trading centres. Rather than attempt to describe all of the compliance responsibilities that the Rule entails, this paper will provide some practical guidance on the key components of an effective compliance programme for broker-dealers that are deemed to be trading centres under the Rule. These include broker-dealers that act as market makers, execute orders as dealers, or effect agency cross-executions.

Supervisory requirements

First and foremost, firms should focus on the core aspects of what the SEC expects: written policies and procedures that are reasonably designed to prevent trade-throughs. This means that firms will have to develop and implement procedures that are intended to prevent the firm from impermissibly trading through protected

quotes. These procedures should be written, vetted through the firm's compliance department, and subject to supervisory and/or compliance review for effectiveness on an ongoing basis.⁹ If the ongoing compliance or supervisory review detects trade-throughs, a firm should take measures to follow up and determine if changes to its operational procedures are warranted to prevent future trade-throughs. At conferences, the SEC staff has suggested that it is not expecting perfection in this regard, in that infrequent, or a *de minimis* amount of, trade-throughs by a firm will not be deemed a violation of the Rule. Rather, the regulator will focus on firms that evidence a large number of trade-throughs, a continuing source of trade-throughs in an area, or a failure to make appropriate corrections to procedures on finding evidence of a trade-through problem.

An important element of the SEC (or FINRA) review of firms during the first year of implementation of the Order Protection Rule will be whether a firm that internally detects trade-throughs performs any follow-up to correct the problem. Undoubtedly, many firms will find that some trade-throughs occur during the early phases of the Rule, despite their best efforts to program compliance into their systems and procedures. A sea change of this magnitude, in terms of trading compliance and operational adjustments, will necessarily result in glitches and unintended mishaps. It is expected that the regulators will initially have some tolerance for a reasonable amount of trade-throughs as firms become adjusted to life under the Rule.¹⁰ What the regulators are unlikely to countenance, however, is a failure by a firm to make a good faith effort to correct a trade-through problem once it has been discovered. Therefore, merely adopting a

series of policies and procedures on trade-throughs will not be enough: a firm must have in place the resources to fix problems so that they do not become recurring incidents.

Operational requirements

In addition to policies and procedures to prevent trade-throughs, firms should adopt procedures to ensure that they are properly relying on exemptions to the Order Protection Rule. Undoubtedly, during examinations of firms for compliance with Regulation NMS, regulators will review whether an exemption is properly used. For example, if a firm designates an order as an ISO, it must make sure either that orders are being sent to execute against all protected quotes at better prices or that there are no protected quotes at better prices. For the same reasons, a firm will need to ensure that it has procedures relating to when it will avail itself of the self-help exception should a market not be providing automatic responses to orders within one second. These procedures should contain the triggers for when the firm will notify a market that the firm believes the market's quotes are no longer automated.

Another critical area in which adequate procedures must be developed involves such use of the self-help exception. A firm relying on this exception will need to maintain information on the circumstances triggering such reliance, its communication with the market from which quotes will be ignored and the response, if any, from the away market to the firm's notification of its invocation of self-help. The SEC and FINRA will scrutinise carefully a firm's usage of the self-help exception during time periods when the firm is the only firm invoking self-help in relation to a particular market.

Likewise, the regulators will review firms' use of other exceptions to the Order Protection Rule. Consequently, firms should retain information to justify use of exceptions, such as the benchmark exception, contingent trade exception, etc. For example, if a firm uses the benchmark exception for a VWAP trade, the firm should retain data to indicate that the transaction was effected on a VWAP basis and the terms of the execution to demonstrate that the trade was, indeed, a VWAP execution. In other words, merely retaining the information that a trade was subject to an exception from the Order Protection Rule may not be enough; rather, a firm may need to retain information to show that reliance on the exception was valid.

Similarly, a firm relying on the stop order exception will have to demonstrate that the order was appropriately marked as a stop, that the stop was '*underwater*' at the time of execution (ie, that the price of the trade-through was lower (higher) than the national best bid (offer)) and that the order was for a customer.¹¹ Firms should scrutinise stop trades to ensure that they were *bona fide* and not merely trade-throughs that were documented after execution as 'stop' transactions.

A host of unresolved issues remain in relation to the Order Protection Rule. For example, how should a firm treat a program trade for which it committed capital on a blind bid basis? The transaction does not fit squarely within the benchmark exception, yet the price of the trade will have been determined on a total program basis, not on the prices of the individual components at the time of execution. Lack of SEC guidance on handling this type of transaction within the Rule will keep compliance personnel guessing regarding the proper treatment. Similarly, convertible preferred securities would present challenges under the Order

Protection Rule. These securities price off the underlying, yet compliance under the Rule will be based on the quotes in the preferred securities. Industry groups have been attempting to obtain SEC relief on these securities, but, at the time of the drafting of this paper, no such relief has been forthcoming.

One area in which the SEC has provided guidance, but in a manner that stretches logic, is that related to net trades for a benchmark order. In its FAQs, the SEC has said that a net trade's compliance with the Order Protection Rule will be based on the price of the transaction as reported to the transaction tape, inclusive of compensation. This position is understandable, because a trade's reported price is the best measure of whether a trade-through has occurred. The SEC goes on, however, in FAQ 3.08, to state that a benchmark trade with compensation added to the price (eg VWAP plus two cents) would disqualify the transaction from the benchmark exception, because the compensation is reasonably determinable at the time of the commitment to execute the order. This position is illogical because the determination of the compensation should be irrelevant in relation to the ability to determine the overall price of the transaction at the time of the commitment to execute the order. Despite industry efforts to point this out to the SEC, its position has not changed. Thus, it is likely that, during regular trading hours, benchmark trades will be effected with an explicit, separately charged commission, so that the benchmark exception will apply.

Record-keeping requirements

The policies and procedures expected of firms will generate enormous amounts of data and information, and firms are trying to sort out how much of such data and information they should maintain to

demonstrate compliance with the Order Protection Rule. Perhaps the greatest source of data will be the amount of protected quote information, because the whole concept of a trade-through depends upon the protected quotes that are in existence at the time of a trade. In its FAQs, the SEC has provided some guidance in this area. In FAQ 6.03, the SEC responded to the question of whether a firm has to maintain a comprehensive database of quotation data so that every trade and ISO can be evaluated. In essence, its response indicated that a firm would not be required to maintain data on all protected quotes during every trading day, as long as it has in place reasonable policies and procedures that include periodic review of compliance with the Order Protection Rule, and as long as it retains sufficient *'firm-specific quotation data'* with which to demonstrate the reasonableness of its compliance reviews. By *'firm-specific quotation data'*, the SEC means the protected quotation data that is received by a firm, with internal time stamps that reflect the time at which it was received. To address the question of what is sufficient data to retain, in FAQ 6.03, the SEC provides an example, whereby a firm randomly selects for review three trading days per month (known only to its compliance personnel) and maintains all relevant 'snapshots' of firm-specific quotation data that are necessary to demonstrate the reasonableness of its policies and procedures.

Although the three-day example is just that — an example — most firms have chosen to use this suggestion as the standard for quote data retention. Nevertheless, even maintaining three days' worth of data on protected quotes will require a massive amount of systems capacity and storage, so firms are pondering whether something less than all of the protected quotes on the three chosen days will be

sufficient. To be on the safe side, a firm should maintain sufficient quotation data from those three days to demonstrate that it did not commit any trade-throughs and that its usage of ISOs was proper. This might entail something far less than all of the protected quotes on the three days. In the example in the FAQ, the SEC specifically notes that a firm could maintain all relevant snapshots of quotation data; a reasonable approach would be for a firm to retain data on all protected quotes just before, during and immediately after every trade that it executes and every ISO that it sends. For a firm that chooses not to trade outside of the national BBO, the firm might retain only a snapshot of the national BBO data for every trade it executes. Of course, there may be other occasions on which retention of quote data may be necessary, such as when a firm is relying on the exemption for flickering quotes. These types of issue will hopefully get sorted out in an iterative process between firms and regulators, during the first year of implementation of Regulation NMS.

Finally, a firm should maintain sufficient data to demonstrate that it is monitoring for latencies in the quotation data it receives. This is important, because whether a firm has committed a trade-through or not will depend upon the protected quotes of the various markets at the time of a trade. The SEC is not requiring that firms obtain quotation data from the markets directly or from the consolidated plans; instead, the SEC clearly permits firms to choose third-party vendors as a source of quotation data. Use of third-party vendors, however, presents a conundrum, because it may be difficult to determine if there is latency in the vendor's quote stream without comparison to another source such as the consolidated plan data. Yet, it will be difficult to make the comparison without

obtaining the consolidated plan data, which would negate using the option of a third-party vendor in the first place. The only guidance provided by the SEC to date is contained in FAQ 6.02, within which the SEC notes that to check for latencies a firm should *'implement reasonable steps to monitor such latencies on a continuing basis and take appropriate steps to address a problem immediately should one occur'*. This guidance does not really spell out the specific steps that the SEC expects firms to take. Unless the next iteration of the FAQ provides more guidance in this area, my suggestion is that firms using third-party vendor data should follow up on any indications that the data source being used may have latencies. For example, if a firm receives a slew of complaints that it effected numerous trade-throughs, yet its internal data does not indicate that the transactions in question traded through protected quotes based on the firm's source of quotation data, then this might prompt a firm to examine whether its quotation source has some latency issues.

CONCLUSION

There remain many unresolved issues regarding the operation of Regulation NMS. Chief among these are the application of the Rule to convertible preferred securities, blind bid program trades and exchange trade funds (other than the very limited relief granted in FAQ 3.18). Unfortunately, other than the FAQs and the several exemptive orders, there are no helpful SEC resources that practitioners can use in addressing implementation issues. The Securities Industry and Financial Markets Association (SIFMA) has established several working groups to analyse Regulation NMS issues, and to bring operational and interpretive problems to the SEC, but while SIFMA's

efforts have helped to prod the SEC into providing guidance in some areas, a host of issues will not be resolved until after the implementation of Regulation NMS.

This paper has touched upon the tip of the iceberg in terms of compliance issues with Regulation NMS. It will be a challenge for firms to sort through the panoply of outstanding issues before the full implementation of the Order Protection Rule. Regulators examining a particular firm are likely to review the firm's efforts pursuant to a test of reasonableness in the first six months after implementation, rather than against an idealised standard of compliance. While a reasonableness standard does not provide a firm with carte blanche to cobble together inadequate procedures, it should provide overall flexibility for firms to differ in relation to how they approach many of the Regulation NMS compliance requirements.

REFERENCES

- (1) See US Securities Exchange Act of 1934 (the 'Exchange Act') SEC Release 34-51808 (9th June, 2005) 70 FR 37496 (29th June, 2005) (the 'Adopting Release'), which is available online at <http://www.sec.gov/rules/final/34-51808.pdf>.
- (2) The adoption of Regulation NMS was not without controversy. In fact, the SEC voted 3:2 to adopt Regulation NMS, with Comms Cynthia L Glassman and Paul S Atkins dissenting. While the dissenting Commissioners criticised Regulation NMS generally, much of their criticism was aimed at the Order Protection Rule. Their separately published written dissent is available online at <http://www.sec.gov/rules/final/34-51808-dissent.pdf>.
- (3) See Securities Exchange Act Release 34-55160 (24th January, 2007, available

- online at <http://www.sec.gov/rules/final/2007/34-55160.pdf>) for the extension of Regulation NMS compliance dates.
- (4) 'NMS stock' means a security, other than an option, for which transaction reports are collected, processed and made available pursuant to an effective national market system plan. This covers stocks listed on a national securities exchange and stocks included in either the National Market or SmallCap tiers of Nasdaq. It does not include stocks that are quoted solely on the OTC Bulletin Board or elsewhere in the OTC market.
- (5) 'Trading centre' means a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system (ATS), an exchange market maker, an OTC market maker, or any other broker-dealer that executes orders internally by trading as principal or crossing orders as agent.
- (6) For example, trading centres will need to establish procedures such as regular exception reports to evaluate their trading and order-routing practices. Trading centres will have to affirm that their policies and procedures have been followed by their personnel and properly coded into their automated systems, and, if not, they will have to identify promptly the reasons why and take remedial action.
- (7) For example, the SEC stated that a single failure to respond within one second generally will not justify future bypassing of another trading centre's quotations, but that, in contrast, many failures to respond will warrant use of the exception. A trading centre making use of the exception must notify the non-responding centre immediately after (or at the same time as) electing this exception, pursuant to reasonable and objective standards contained in its policies and procedures.
- (8) Securities Exchange Act Releases 34-54389 (31st August, 2006, available online at <http://www.sec.gov/rules/exorders/2006/34-54389.pdf>), 34-55883 (8th June, 2007, available online at <http://www.sec.gov/rules/exorders/2007/34-55883.pdf>), and 34-55884 (8th June, 2007, available online at <http://www.sec.gov/rules/exorders/2007/34-55884.pdf>).
- (9) See, eg, NYSE Information Memorandum 07-44 ('Regulation NMS') for a brief exposition of the NYSE's views on supervisory compliance.
- (10) Reports of NYSE and American Stock Exchange inquiries into firm's NMS procedures during May 2007 is cause for some concern in this area. Purportedly, the two Exchanges were asking to examine some members' Regulation NMS procedures before the implementation phase-in date of 9th July, 2007.
- (11) See FAQ 3.10 (available online at <http://www.sec.gov/divisions/marketreg/nmsfaq060807.htm>).