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A legal update from Dechert's Financial Services Group

SEC Settles with Market Centers for Allegedly Erroneous "Dash 5 Reports"

Introduction

On October 18, 2005, the Securities and Exchange Commission (the "SEC" or the "Commission") announced a settled enforcement action (the "Order")[1] against Instinet, LLC ("INCA") and INET ATS, Inc. ("INET") for alleged violations of Rule 11Ac1-5 and Section 11A of the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 11Ac1-5 requires market centers[2] to publish order execution quality reports (commonly referred to as "Dash 5 Reports") for each calendar month to provide detailed information about the price and speed at which market centers execute orders.

In settling the proceeding, the SEC ordered INCA and INET to cease and desist from committing or causing any violations and any future violations of Rule 11Ac1-5 and Section 11A of the Exchange Act. INCA and INET also agreed to pay a penalty of $350,000 each, and agreed to adopt a number of remedial undertakings, including retention of an independent third party to confirm the accuracy of their Dash 5 Reports and retention of a third party regulatory auditor to conduct a comprehensive regulatory audit of their compliance programs relating to Rule 11Ac1-5. INCA and INET consented to the entry of the Order without admitting or denying the SEC's findings.

Summary

The SEC alleged that from June 2001 through May 2004, INCA and INET repeatedly published monthly Dash 5 Reports that contained inaccurate order execution quality information. The errors in the reports included the misclassification of shares, miscounting of cancelled shares, improper exclusion of orders, improper calculations based on erroneous times, improper categorization of orders, inaccurate order execution information, incorrect calculation of spreads, and other incorrect calculations.

On the basis of the above alleged findings, the SEC found that INCA and INET willfully violated Rule 11Ac1-5 and Section 11A of the Exchange Act because INCA and INET failed to test their automated systems adequately, and failed to respond effectively after NASD staff, SEC staff, and third parties detected the repeated errors. Pursuant to their settlement with the SEC, INCA and INET paid $700,000 in civil penalties ($350,000 each) and agreed to institute remedial undertakings.[3] In addition to

1 Rel. No. 34-52623 (October 18, 2005).

2 A market center is any exchange market maker, OTC market maker, alternative trading system, national securities exchange, or national securities association. *See* Rule 11Ac1-5(a)(14).

3 INCA and INET agreed to retain a third party regulatory auditor ("Regulatory Auditor") to conduct a comprehensive regulatory audit of the Rule 11Ac1-5 compliance program of INCA and INET by the end of 2006. Within 45 days of the completion of the audit, the Regulatory Auditor will submit to the Commission staff, the NASD, and the Boards of Directors of INCA and INET its assessment as to (i) whether the policies and procedures of INCA and INET are reasonably designed and effective to detect and deter violations of Rule 11Ac1-5, and (ii) whether INCA and INET are in substantial compliance with such policies and procedures. INCA and INET will bear the full expenses of the regulatory audits and will also retain an independent third party to confirm the accuracy of their Dash 5 Reports for the next five years. *See* Order at n. 2.

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settlement with the SEC, INCA and INET also settled related charges based on violations of NASD rules and paid NASD $775,000 in penalties.

Rule 11Ac1-5

On November 17, 2000, the Commission adopted Rule 11Ac1-5, which requires market centers that trade national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality.[4] The Commission adopted that rule, along with a companion Rule 11Ac1-6 (“Dash 6 Rule”), which requires broker-dealers that route customer orders in equity and option securities to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. The Commission stated that “taken together, the rules should significantly improve the opportunity for public investors to evaluate what happens to their orders after they submit them to a broker-dealer for execution.”[5]

On April 6, 2005, the SEC adopted new rules regulating the National Market System (“Regulation NMS”) and redesignated Rule 11Ac1-5 as Rule 605.[6] The SEC has designed Regulation NMS to establish extensive baseline rules to govern how trading centers and broker-dealers interact with the rest of the national market system when routing orders for execution, displaying quotations, and disseminating market data to the public.[7] The Commission retained the Dash 5 and 6 requirements as part of its overhaul of market structure and order routing requirements.

Discussion

INET and INCA are both subsidiaries of Instinet Group Incorporated. INET (known as the Island ECN Inc. (“ISLD”) until November 2003) operates as an alternative trading system which constitutes one of the largest venues of NASDAQ-listed equity trading. According to the SEC findings, the Dash 5 Reports for ISLD and INET were problematic. In August 2002, although an ISLD employee determined that ISLD’s Dash 5 Report contained errors because it was based on incomplete quote data, ISLD did not conduct a follow-up review to determine if the incomplete quote data had affected other reports. Additional problems with timely and complete quote data continued to affect ISLD’s Dash 5 Reports throughout 2003.

In 2004, after ISLD became INET, a variety of programming issues caused INET’s reports to be erroneous as well. According to the SEC findings, the programming issues included incorrect calculations for effective and realized spreads, improper determinations of whether trades were executed at or outside of the quote, misclassification of orders, failure to include all order execution information, and incorrect trade execution information caused by an incorrect price divisor. Although INET assigned an employee who had technological expertise to research the above errors, the SEC alleged that INET failed to reassess its entire Dash 5 Reports program in light of these repeated errors.

INCA is a global electronic securities broker that provides its customers with electronic and sales trading execution services, enabling buyers and sellers to trade securities directly and anonymously with one another or to execute trades in global securities markets. INCA’s customers consist primarily of institutional investors such as hedge funds, mutual funds, and pension funds. Similarly, the SEC alleged that the errors in INCA’s Dash 5 Reports stemmed from a variety of sources. For example, system errors led to the improper handling of daylight-savings time. A change in the vendor used by INCA to supply market data caused still more errors. When each error was discovered, INCA corrected the programming to eliminate the error going forward, but without reviewing the whole system for accuracy.

On the basis of these facts, the SEC determined that because INET and INCA were aware of the systemic and human errors that caused erroneous Dash 5 Reports, but failed to remedy the deficiencies adequately, INET and INCA willfully violated Rule 11Ac1-5 and Section 11A of the Exchange Act, which require market centers to make available to the public accurate, standardized, monthly reports of statistical information concerning their order executions.

Conclusion

This is the first action that the SEC has taken against market centers for publishing erroneous Dash 5 Reports. We may draw several conclusions from this

4 *See Supra* n. 1.

5 Rel. No. 34-43590 (November 17, 2000).

6 Rel. No. 34-51808 (June 9, 2005).

7 *Dechert Onpoint: Divided SEC Adopts Regulation NMS* (September 2005/Issue 15).

settled case that may be useful for other regulated entities. First, the SEC may charge a regulated entity with a willful violation of a rule, even if that entity did not intend to violate the specific rule. The Order states that INCA and INET willfully violated Rule 11Ac1-5 and Section 11A of the Exchange Act, noting that "'willfully,' as used in this Order means intentionally committing the act which constitutes the violation .... There is no requirement that the actor also be aware that he is violating one of the [SEC's] Rules or [federal securities] Acts."[8]

Second, the SEC expects a regulated entity to produce accurate reports, even if an erroneous report would put the entity at a competitive disadvantage**.** The Commission brought the case even though some errors made the quality of executions look worse than they actually were. The Order notes at 2 that:

> The effect of the erroneous reports varied. In some instances, the reporting errors resulted in execution quality statistics that made the Respondents' execution quality appear to be worse than was actually the case. In other instances, the reporting errors resulted in execution quality statistics being reported that made the Respondents' execution quality appear to be better than was actually the case.

[8] Order at n. 2.

One might have characterized the Dash 5 Reports that made the execution quality reports appear worse than they actually were to be harmless errors. In other words, erroneous Dash 5 Reports that made the execution quality of INET and INCA look worse than it was would have unduly discouraged broker-dealers from routing orders to those market centers, and presumably would have harmed the market centers' ability to attract orders. Clearly, the SEC is insisting that market centers provide accurate Dash 5 Reports—regardless of whether the reports are too rosy or too grim.

Finally, the Order should encourage regulated entities to be certain that experts in technology, law, and compliance effectively communicate with one another. If a regulated entity employs technological means to address regulatory requirements, professionals in all disciplines must be sure that the technological means fulfill the regulatory obligations initially and on an ongoing basis.

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