Securities Regulation Daily Wrap Up, TOP STORY—2d Cir.: Exchanges did not breach contracts by allowing faster market data access, (Sept. 26, 2016)

Securities Regulation Daily Wrap Up

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By Kevin Kulling, J.D.

The Second Circuit Court of Appeals has affirmed the dismissal of a breach of contract action brought against several national exchanges for allegedly providing an unfair data advantage to high frequency traders. The court noted that while Regulation NMS requires that exchanges transmit market data to the information processor and to preferred customers at the same time, there was no requirement that customers receive the data at the same time (*Lanier v. BATS Exchange, Inc.*, September 23, 2016, Lynch, G.).

Claims against exchanges. Harold Lanier filed three materially identical lawsuits in the United States District Court for the Southern District of New York, alleging that several exchanges had breached their contracts with him by providing preferentially fast access to so-called "Preferred Customers" who purchased data and received it from the exchanges directly via the exchanges' proprietary feeds.

Lanier contracted with the exchanges to receive consolidated data via a securities information processor. Lanier claimed that the exchanges allowed customers who paid for direct market data feeds from each exchange to receive market data faster than the securities information processor received the same data. The preferred customers received market data up to 1,499 microseconds faster than subscribers, Lanier alleged. Allowing the preferred customers to receive that information faster was a breach of the subscriber agreement, according to Lanier.

District court dismissal. The district court dismissed Lanier's breach of contract claims on the ground that the court lacked subject matter jurisdiction because the claims were preempted by the Exchange Act and relevant SEC regulations. The district court said that the federal securities scheme preempted state law claims and required the claims to be adjudicated first by the SEC and not the courts.

Appellate court holding. Ruling on Lanier's challenge to the dismissal, the appellate court affirmed the decision to grant the motion to dismiss but for different reasons. The Second Circuit concluded that the district court erred in holding that it lacked subject matter jurisdiction, but affirmed the dismissal of the complaints for failure to state a claim. The appellate court concluded that Lanier did not plausibly allege that the exchanges violated any contractual obligation by simultaneously sending data to both the processor and the preferred customers that was received earlier by the preferred customers.

Regulatory framework. The appellate court noted that the exchanges were required to comply with the SEC's rules and regulations regarding distribution of information with respect to quotations for or transactions in any security.

The SEC adopted Regulation NMS in 2005 to modernize and strengthen the national market system (NMS) for equity securities. Every exchange that trades NMS securities must file a transaction reporting plan with the SEC for its approval. With respect to dissemination of data, Regulation NMS requires that the quotation and transaction information must be distributed on terms that are not unreasonably discriminatory.

Each NMS Plan designates a processor, which collects data from each participating exchange, consolidates the data, calculates the national best bid and offer and updates last sale information for each security and then disseminates that data via a subscriber feed.

Subscribers, such as Lanier, gain access to market data via the processors by signing contracts, or subscriber agreements, that incorporate by reference the SEC rules, the Exchange Act, and the relevant NMS plan. Exchanges are also authorized to distribute their own data independently as long as they also continue to provide data through the processor pursuant to an NMS plan.

In adopting Rule 603 as part of Regulation NMS, the SEC specifically noted that the regulation did not require that the receipt of data by end users be synchronized. Rather, the SEC explained that Rule 603 prohibited an exchange from transmitting data to a vendor or user any sooner than it transmits the data to the processor.

Failure to state claims. Lanier argued that the exchanges made promises in the various subscriber agreements to deliver current market data in a fair and non-discriminatory manner as promptly as possible. Lanier contended that the contract terms prohibited preferred customers from receiving market data and best price information before the processor.

But the appellate court found no such requirement. To the extent that Lanier's claims that the obligation to ensure that the processor receives data no later than the preferred customers derives from the incorporation by reference of SEC regulations, that argument turns on an interpretation of the relevant regulations that conflicts with the agency's own stated interpretation, and is thus preempted, the court said.

To the extent that the complaints may be read to allege that the exchanges undertook self- imposed contractual obligations separate from their regulatory obligations regarding the dissemination of market data, such allegations were wholly conclusory and divorced from the text of the subscriber agreement and failed to state a claim for breach, the court found.

The case is No. 15-1693.

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Companies: Bats Exchange, Inc.; Bats Y-Exchange, Inc.; Chicago Board Options Exchange Inc.

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