



SENATE BANKING SUBCOMMITTEE HEARING

OVERVIEW

For questions please contact [Hope Jarkowski](#) at (202) 547-3035.

Today, the Senate Banking Subcommittee on Securities, Insurance, and Investment met in open session to conduct a hearing entitled “Regulatory Reforms to Improve Equity Market Structure.”

Key Takeaways

- The SEC expects and SEC Staff recommendation to publish the Consolidated Audit Trail (CAT) plan for notice and comment very soon.
- The SEC expects to issue a proposal for enhanced institutional order routing transparency in 2016.
- Senator Crapo is eager to see progress across the SEC’s agenda for equity market structure review.
- Senator Warner strongly supports a maker-taker pilot program, which the SEC said will be introduced in early form by the SEC’s Equity Market Structure Advisory Committee in late April.

SUMMARY

Opening Statement and Testimony

[Subcommittee Chairman Mike Crapo \(R-ID\)](#)

- The landscape of stock markets and trading today is substantially different than it was twenty, ten, or even five years ago.
- Regulations and technological innovation have moved stock trading from the floors of exchanges to virtually all trading being conducted electronically on automated markets. Technology and innovation has benefitted investors by leading to tighter spreads, lower costs, and more efficient markets.
- However, the expansion of trading venues, speed, and mandated interconnectedness of exchange and market participants has raised questions regarding market complexity and resiliency.
- For the past several years the SEC and FINRA have been working to better understand whether their market structure rules have kept pace with changes in trading technology and practices.
- In 2014, the Banking Committee held a hearing with a broad mix of market participants to examine the role of regulation in shaping today’s markets as well as whether these markets are as resilient and stable as they should be.
- Several witnesses at the hearing argued that Regulation NMS, a set of SEC market structure rules that passed by a 3-2 vote over 10 years ago, needed to be reexamined.
- Later in the year, SEC Chair White provided an update to her market structure agenda in a response to a letter Senator Johnson and I sent and highlighted three fundamental policy questions the Commission would be focusing on:
 - The trade-through restrictions in Rule 611 of Regulation NMS and whether they should be rescinded or modified.

- The current regulatory model for exchanges and other trading venues and whether it makes sense for today's markets.
- The maker-taker fee structure, including the related issue of restrictions on locking and crossing quotations in Rule 610 of Regulation NMS.
- These are complicated issues and I appreciate the data-driven approach by the SEC and FINRA and the extensive comments from market participants, investors, and academics.
- Today, this Committee hopes to hear from our witnesses about what lessons were learned from recent market disruptions and what steps need to be taken to strengthen the operation of the markets.

Subcommittee Ranking Member Mark Warner (D-VA)

- Over the past few decades, we have seen remarkable technological progress and innovation in our securities markets, coupled with substantial regulatory reform. Some of these advances and reforms, including decimalization, have brought considerable rewards for individual investors by narrowing spreads and increasing liquidity.
- Most trades today can happen within fractions of a second, providing good prices and counterparties for those seeking to buy equities around the world. But at the same time, we have seen increased volatility and periodic dislocations.
- It is clear much work around market structure remains.
 - **First**, in era of microsecond trading, reevaluate the way our stock markets function.
 - **Second**, explore additional pilots (including maker-taker).
 - **Third**, examine the role dark pools play in market structure, particularly in light of recent settlements with the SEC and New York Attorney General. The original rationale for dark pools was to conduct block trading but that seems to have diminished into venues where the average trade size is only 187 shares.
 - **Fourth**, need regulatory tools necessary to conduct adequate market oversight, including the CAT.

[Stephen Luparello, Director of the Division of Trading and Markets \(TM\), SEC](#)

- A review of Equity Market Structure was a priority for the SEC in 2015 and continues to be a priority in 2016. He noted the recent rule proposals regarding changes to Reg ATS, the Tick Size Pilot program and Rule 15b9-1 to require FINRA membership for broker-dealers who are not currently registered with FINRA.
- Three key elements of EMS review:
 - Data Driven
 - Seeking wide range of views outside of standard notice and comment — e.g., through the EMSAC, roundtables, other concept release
 - Comprehensive in scope – these issues are interrelated — SEC does not address issues in isolation
- Four major policy initiatives:
 - CAT — staff will be in a position soon to recommend to the Commission to publish the CAT for notice and comment

- Institutional order routing transparency — the Commission is working on rules for mandating standard order routing disclosures — this recommendation will move forward in 2016
- Anti-disruptive trading rule — Staff is developing a recommendation for the Commission to consider that would address the use of aggressive, destabilizing trading strategies in conditions when they could most seriously exacerbate price volatility
- Pilot program on maker take fee structures — subcommittee of EMSAC is assessing and will have a recommendation for discussion at the late April EMSAC meeting

Richard Ketchum, Chairman and CEO, FINRA

- I believe there are three key aspects of the markets that securities market participants and regulators should always be working to strengthen: market fairness, market transparency and market liquidity.
- Cross-market surveillance — FINRA has an innovative program that allows detection of manipulation across asset classes.
- Transparency — FINRA is working on a series of initiatives that allow FINRA to receive more information — for example, a call for ATs to provide more depth and information.
- The SEC's EMSAC, of which I am a member, is examining current regulatory models for exchanges and other venues, rules on eliminating trade-throughs, capping access fees and other rebates.

Discussion

Crapo (R-ID): -

- How soon will we get answers on questions that have been asked for a long time — even before Chair White laid out her priorities in 2014? What are the top two proposals that we can get to these proposals so we can start moving — give me a timeframe? *Luparello:* Top two are the ones that are “next up” — CAT and institutional order routing disclosure rule — Rule 606. Chair White recently said that she wants to have CAT approved and processor plan done in 2016 — there is hope that the Staff will recommend that the plan will be put for notice and comment in coming few weeks; *Ketchum:* On CAT, FINRA does a substantial amount of surveillance — the ability to move from a two-step review process to an ability to identify customers dramatically reduces false positives and dramatically increases ability to monitor wrongdoing. FINRA commends the SEC for the exemptive order issues yesterday on moving CAT forward. Now is the right time to look at maker-taker and doing a pilot. Collectively, looking at August 24th and other recent disruptions, the work and steps taken worked well vis a vis what was in place before the Flash Crash but more should be done.
- What are your views on FINRA and MSRB harmonizing of disclosure of fixed income markups? *Ketchum:* disclosure of mark ups will result in more efficient pricing
- The EMSAC has four subcommittees — what are the main options that are being considered? *Luparello:* The EMSAC has been in place for about a year — it is still fairly nascent but they continue to develop a range of initiatives for consideration; *Ketchum:* Best ex and venue issues from the

standpoint of the regulatory plans. The great advantage of subcommittees on EMSAC is that they allow them to bring in a variety of experts.

- What issues in fixed income markets need attention? *Luparello*: Complimented FINRA and MSRB with respect to disclosure of markups. Also spend a lot of time thinking about encouraging more transparency without interfering with natural industry development of more transparency; *Ketchum*: Agree with Steve and also acknowledged the Treasury securities report and the Treasury Department's recent Request for Information – at minimum, we need to move forward to get full regulatory reporting and continue to look at the lack of transparency in the Treasury markets.

Warner (D-VA):

- It has been six years on the CAT and his patience is wearing thin — since the SEC doesn't have jurisdiction over the futures markets, how are you considering expansion of CAT into other asset classes. How are you dealing with the jurisdiction issues as between the CFTC and SEC? *Luparello*: The CAT could not be a higher priority at the SEC. The CAT plan participants have been identifying potential expansions into other markets to address issues such as those on August 24th; *Ketchum*: There is nothing more important than moving CAT. Including futures and the credit default swap markets would be a huge step forward and efforts should be made to move across jurisdictional lines — FINRA has worked with the CME over time, but need to move to bringing the markets together in a more formal way.
- Where do things stand with respect to a Maker Taker Pilot? *Luparello*: Looks forward to EMSAC recommendation for a maker-taker pilot in late April; *Ketchum*: Support a broader pilot and should be done in a data driven way — this is the right time to look and make changes.
- Market Making — Refining the definition of market making and incentives around market making. Lots of broad based rationales given for market makers to be in the market when there are disruptions, etc. Thoughts? *Luparello*: Giving market makers obligations that they do not currently have in return for giving them benefits that they do not currently have is an important issue to consider.
- With respect to Algo Tagging — in the context of reconstructing market meltdowns, is looking at code something that you are considering? *Luparello*: As a general matter, most broker-dealers look at their code as part of their required books and records. With respect to reconstructing a market disruption, it is important to know what order flow came from those algos and that information lies in the code. The SEC is, however, sensitive to the “secret sauce” point that the code represents proprietary information of a firm; *Ketchum*: FINRA is focused on being better able to recreate trading behavior and creating greater accountability with respect to the creation and supervision of algos by a broker-dealer.

Warren (D-MA):

- Focused on the self-regulatory aspect of FINRA — FINRA is an independent non profit and the FINRA website says it is dedicated to investor protection. However, the University of Chicago's Booth School of Business released a study this week on the disciplinary records of registered advisors and brokers and found that 1 in 13 had a documented record of criminal, civil or regulatory misconduct. As the head of FINRA, what are you doing to protect investors against these folks?

Ketchum: Read the study with great interest and find it dismaying that such firms would hire such individuals — FINRA bars up to 1000 a year. FINRA cares very much regarding recidivism and bars firms that are unable.

- Forced arbitration awards — What is FINRA planning to do to force firms to pay arbitration awards? *Ketchum*: If a FINRA firm continues to do business after not paying an arbitration award they will be barred.

Donnelly (D-IN):

- Acknowledged complexity with respect to the number of exchanges and dark pools. To Mr. Ketchum— can you describe the changes in complexity over your career? Do regulators have the tools to keep pace with these regulatory developments (e.g., Flash situations and others)?
Luparello: Jurisdictionally, we have the tools. With respect to the ability to gather and analyze data, things have improved, but still more to do; *Ketchum*: On the market surveillance side, have dramatically better ability than ever before to monitor across markets.
- With respect to co-location, do you look for things that seem to have no real reason? *Luparello*: The important question regarding whether there is a speed at which there is diminishing returns. Co-location must be provided on equal terms to all of their members – it is an important question as to whether people are taking speed advantages in an appropriate way.