CLIENT UPDATE

SEC CHAIR WHITE SETS EQUITY MARKET STRUCTURE AGENDA

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INTRODUCTION

Mary Jo White, the Chair of the Securities and Exchange Commission (the "SEC"), recently delivered two speeches with important implications for the future structure of U.S. equity markets. The first, delivered on June 5, 2014, discussed various initiatives to improve equity market structure. The second, delivered on June 20, 2014, addressed the importance of intermediation in the securities markets and the roles that technology and competition play with respect to various types of market intermediaries such as exchanges, dark pools, brokers and dealers. In both speeches, Chair White expressed her belief that the equity markets are not rigged or fundamentally unfair, but nevertheless could—with updated or different regulations—function more efficiently and with even greater fairness than they currently do.

Coming on the heels of Michael Lewis's popular book, *Flash Boys: A Wall Street Revolt*, as well as years of debate within the industry and at the SEC, Chair White's speeches seem timed to reassure both investors and the markets by putting all participants on notice that change will come. However, whether that change will overhaul current market structure or simply make discrete modifications

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remains to be seen. From the speeches' tone and content, Chair White certainly hopes that it will be change we can all believe in.

This update first broadly outlines current equity market structure. We then describe some of the shortcomings with the current structure that have been identified. Next, we summarize Chair White's speech of June 5 and its various proposals, as well as the related discussion from Chair White's speech of June 20.[2] Finally, we look for trends in the speeches by which market participants can evaluate future SEC initiatives.

On the whole, Chair White has staked out a position for broadening the SEC's regulatory authority to reach more directly a larger number of market participants and their technology, in an effort to continue to improve execution quality and market infrastructure. The role of the SEC as technology regulator will be a relatively new one, and reflects its acknowledgement that computers, even though run by humans, have come to dominate trading.

CURRENT EQUITY MARKET STRUCTURE

In 1975, Congress adopted Section 11A under the Securities Exchange Act of 1934 (the "Exchange Act"), which directed the SEC to establish a national market system[3] founded on five objectives: (i) economically efficient execution of transactions, (ii) fair competition among liquidity providers, (iii) the availability to all market participants of quote and last trade information, (iv) execution of orders in the best market, and (v) the opportunity to trade without the participation of a dealer.[4] Congress believed that integrating the previously unconnected regional securities markets would advance these objectives[5] and such integration had become possible due to the developments in data processing and communications technology at the time.[6]

Regulation NMS,[7] which came into effect in 2007, provides the general regulatory framework for the current equity market structure. The regulation's name reflects its purpose: to update and strengthen the "national market system" for equity securities.

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2 The June 20 speech also addresses fixed income market structure, which is beyond the scope of this update.

3 15 U.S.C. § 78k-1(a)(2).

4 15 U.S.C. § 78k-1(a)(1)(C).

5 15 U.S.C. § 78k-1(a)(1)(D).

6 15 U.S.C. § 78k-1(a)(1)(B).

7 17 CFR 242.600–612.

Regulation NMS updated the regulatory structure around the national market system in light of the organic changes in the equity markets that had taken place since 1975, especially the increasing use of computerized trading systems by all market participants. The regulation required exchanges, alternative trading systems ("ATSs") and broker-dealers to implement policies and procedures (usually through programming their systems) reasonably designed to (i) protect best-priced orders, (ii) promote fair and non-discriminatory access to quotations and greater price transparency, and (iii) force trading centers to more quickly respond to orders. The responses of different market participants to this regulation, as well as other rule changes such as the order handling rules,[8] decimalization[9] and Regulation ATS[10] have done much to shape the present trading landscape.

SHORTCOMINGS IDENTIFIED WITH THE CURRENT EQUITY MARKET STRUCTURE

According to a number of commentators and regulators, the current equity market structure is not as efficient or as fair as it should be. First, there may be too many trading centers (sometimes referred to as "fragmentation"),[11] and some of these centers lack transparency. The trading centers competing for order flow include both "lit" markets (like exchanges) that publish quotes for all to see, and "dark" markets that do not disclose the trading interest they receive (like "dark pools" (ATSs operated by a broker-dealer) and broker-dealer internalization engines). Lit markets offer transparency through published quotes, and establish the National Best Bid and Offer ("NBBO"), the price at which brokers must guarantee their customers execution under Regulation NMS. In contrast, while dark venues rely on the NBBO to establish the prices at which they trade, they provide anonymous execution and little information leakage. Exchanges, moreover, publicize how they function, whereas dark venues generally do not.

Second, as technology has become integral to the operation of the equity markets, the risks to market stability have increased. While technology has greatly improved the efficiency of markets, it can also allow severe problems to develop quickly, as evidenced by some of

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8 17 CFR 240.11Ac1-4 (Display Rule) and 11Ac1-1 (Quote Rule).

9 Securities Exchange Act Release No. 42360, *Order Directing the Exchanges and NASD To Submit a Decimalization Implementation Plan* (Jan. 28, 2000), *available at* http://www.sec.gov/divisions/marketreg//34-42360.htm.

10 17 CFR 242.300–303.

11 SEC, *Equity Market Structure Literature Review Part I: Market Fragmentation* (Oct. 7, 2013), *available at* https://www.sec.gov/marketstructure/research/fragmentation-lit-review-100713.pdf; Securities Exchange Act Release No. 42450, *NYSE Rulemaking: Notice of Filing of Proposed Rule Change To Rescind Exchange Rule 390*; *Commission Request for Comment on Issues Relating to Market Fragmentation* (Feb. 23, 2000), *available at* http://www.sec.gov/rules/sro/ny9948n.htm.

the systems disruptions in the last few years.[12] Technology influences trading in numerous ways, perhaps most importantly by stitching together the diverse centers of liquidity, thereby helping market participants route orders and access liquidity in both lit and dark markets. Market participants use several systemic methods to "see" liquidity, including (i) linkages between markets, (ii) sending, receiving and canceling orders and indications of interest (sometimes called "pinging"), (iii) trading algorithms, and (iv) consolidated market data feeds. The most sophisticated players (including high-frequency traders) use highly complex versions of these technologies, as well as low-latency networks and co-location,[13] for faster processing of information, routing of orders and execution of trades.

Third, high-frequency trading ("HFT") may detract from the quality of equity markets. Generally, HFT refers to professional proprietary traders using highly sophisticated systems and strategies to generate large numbers of orders and trades on a daily basis, but canceling most of those orders and ending up with flat or near flat positions at the end of a trading day. HFT looks to profit from extremely short-term trading derived from speed and technology advantages. Strategies vary and include passive market making, arbitrage, exploitation of structural vulnerabilities and anticipation of intra-day movement, but typically rely on entering and exiting positions quickly and taking advantage of minor (fractions of a penny) movements in market prices. HFT has received a lot of focus in recent months, although the SEC recognized potential issues with HFT at least as early as 2010 in its concept release on the U.S. equity market structure.[14]

Fourth, broker conflicts of interest may inhibit best execution. Trading centers pay brokers for order flow and use other fee structures to attract orders. But when fees and payments are not passed through from brokers to customers, this practice may create a conflict that brokers—that are required to route customer orders to the trading center that will provide best execution—cannot effectively manage. The Senate Permanent Subcommittee on Investigations held hearings on this topic on June 17, 2014.[15]

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12 *E.g.*, SEC, *SEC Charges NASDAQ for Failures During Facebook IPO* (May 29, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575032; *Findings Regarding the Market Events of May 6, 2010, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues* (Sep. 30, 2010), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

13 "Co-location" refers to the placement of proprietary trading systems at or near the location of systems for exchanges.

14 Securities Exchange Act Release No. 61358, *Concept Release on Equity Market Structure* (Jan. 14, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-61358.pdf.

15 Permanent Subcommittee on Investigations, *Subcommittee on Investigations To Examine Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets* (June 16, 2014), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-on-investigations-to-examine-conflicts-of-interest-investor-loss-of-confidence-and-high-speed-trading-in-us-stock-markets.

CHAIR WHITE'S SPEECH ON ENHANCING EQUITY MARKET STRUCTURE

With the above-mentioned shortcomings in mind, SEC Chair Mary Jo White delivered a speech on June 5 that focused on how the SEC has sought to enhance equity market structure.[16] Chair White identified five main areas of concern and discussed several new initiatives designed to improve the functioning of the markets in these areas.

First, in the category of preventing market instability, Chair White noted several SEC accomplishments, including the following proposed and/or implemented rules: (i) "limit up-limit down" to moderate price instability for individual stocks and market-wide circuit breakers to do the same for the broader markets, (ii) the Market Access Rule (SEC Rule 15c3-5) requiring broker-dealers to implement better risk controls, and (iii) proposed Regulation SCI[17] designed to place stricter requirements on the technologies used by exchanges, ATSs, clearing agencies and securities information processors ("SIPs"). She also noted the continuing dialogue with industry members that has resulted in technology audits of the SIPs and other practices that strengthen market infrastructure systems that are "single points of failure."

Second, Chair White focused on technology, including HFT, as a potential source of both market instability and unfairness. As the centerpiece initiative on this issue, Chair White indicated that she will seek to bring HFT and certain other unregulated market participants into the fold of regulation by requiring them to register as dealers and members of FINRA. In addition, in order to reduce instability, the SEC has been working on rules to eliminate disruptive trading. The SEC has also been developing recommendations to improve firms' risk management of trading algorithms and to enhance regulatory oversight of their use.

To ensure that technological advantage does not lead to unfairness, the SEC will ask the exchanges and FINRA to consider including a time stamp in the consolidated data feeds, a measure that the SEC believes will improve the monitoring of latency and the assessment of regulatory compliance. The SEC also will seek disclosure from exchanges on how and for what purpose they use data feeds.

Third, Chair White discussed enhancing market transparency and examining trading venue regulation. In her view, the lack of market transparency in dark venues (both ATSs and broker internalization) and the fragmentation of trading interest are areas of concern.

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16 *Available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542004312.

17 Regulation Systems Compliance and Integrity, Securities Exchange Act Release No. 69077 (March 8, 2013), 78 Fed. Reg. 18084 (Mar. 25, 2013), *available at* http://www.sec.gov/rules/proposed/2013/34-69077.pdf.

The SEC will attempt to remedy these issues by exploring additional regulation of ATSs and undertaking a comprehensive review of the SEC's current regulatory approach for trading venues.

Fourth, the SEC will focus on conflicts of interests created by payment for order flow and other fees. The SEC has three ongoing initiatives to address this issue. It is developing a rule to enhance order routing disclosures in a manner that would address gaps left by current SEC Rule 606 under Regulation NMS. Next, the SEC is asking exchanges to conduct a comprehensive review of their order types and how they operate in practice, including an assessment of whether certain order types can be eliminated. Finally, the SEC is considering more generally questions relating to conflicts of interests between brokers and their customers.

Fifth, the SEC will continue to press for changes that incentivize small issuers to access the public markets. These efforts will start soon with a pilot program to allow wider tick sizes for the stocks of smaller companies. The Chair made clear in her remarks that she regards the needs of smaller companies and their investors as an area of vital concern, and she is open to further proposals for assisting them.

The Chair concluded her speech by describing two measures to facilitate engagement by market participants with the SEC's initiatives. First, the SEC will populate its market structure website with summaries of key issues that provide a framework for further analysis. Second, the Chair also is recommending that the SEC establish a new Market Structure Advisory Committee.

CHAIR WHITE'S SPEECH ON INTERMEDIATION

Two weeks after giving her speech on improving equity market structure, Chair White elaborated on some of the same issues in another speech devoted to the topic of intermediation in modern securities markets.[18] First, she stressed the importance of technology as a driving force in shaping equity market structure. Technology is one of the "constraints that establish[es] the boundaries for interactions between buyers and sellers."[19] Thus as technology changes, regulation must change in response. Chair White dismissed as without support the view attributing the rise of HFT to the implementation of Regulation NMS. While she agreed that regulation can have unintended consequences, she argued that HFT was not one of them. HFT, she noted, is not unique to markets

[18] *Available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542122012.

[19] *Id*.

subject to Regulation NMS and is a characteristic of trading in the markets for many other asset classes.

Second, Chair White highlighted the dangers that intermediation can pose. Conflicts of interests by exchanges and brokers can inhibit best execution, while excessive intermediation by dealers can unnecessarily increase trading costs to investors. Dealers may insert themselves between buyers and sellers when they are not really needed, and because their profits and costs may not be transparent, dealers may trade at prices that are not driven by competitive forces. A challenge that the SEC faces is how to appropriately harness competition and technology to prevent such undue costs from being imposed on consumers, while nevertheless providing dealers with sufficient economic incentives to provide liquidity and otherwise perform their role.

WHERE CHAIR WHITE'S SPEECHES MAY LEAD

We see three trends from Chair White's speeches. First, the SEC has decided that it needs to become a technology regulator, focused on the technology infrastructure challenges at both the individual market-participant level and the broader market level. This role is in addition to the SEC establishing the trading rules that all participants and their technology must obey. Second, the SEC will seek to bring previously unregulated players into the fold of FINRA membership and broker-dealer registration, with the attendant responsibilities and scrutiny. Third, the SEC is committed to improved transparency in the markets as a means to improving execution quality.

The Technology Regulator

For ideas about how the SEC will regulate technology, it is instructive to look at proposed Regulation SCI. When first proposed, most commentators discussed the "trees" (individual proposals within Regulation SCI), as opposed to the "forest" (the SEC regulating technology activities). If Regulation SCI establishes the paradigm pursuant to which the SEC regulates market participant technology, then we might expect that each market participant will be required to:

- Establish policies and procedures relating to the capacity, integrity, resiliency and security of its technology systems, including ensuring that the systems operate in a manner compliant with relevant federal securities laws and rules;
- Take timely corrective action in response to systems disruptions, systems compliance issues and systems intrusions;

- Notify and provide the SEC and perhaps other market participants with information when systems issues occur and corrective actions are taken, or in advance of material changes in its systems;
- Conduct an annual review of its compliance with SEC technology regulations and submit a report of the review to its senior management and the SEC; and
- Provide SEC staff with access to its systems to assess compliance.

We presumably can expect these concepts and requirements to apply to, for example, the following activities by some or all market participants: (i) trading algorithm and smart order router development and operation, (ii) the SIPs and other market data sources, (iii) compliance with the Market Access Rule, (iv) all types of trade reporting, (v) electronic books and records, and (vi) consolidated audit trail submissions (once it commences operation). The new group of "dealers" that the SEC will seek to regulate will, as a matter of course, become subject to any new regulation of technologies.

Registering a New Class of Dealers

The unregulated market participants that Chair White seems most concerned with regulating include those who engage in HFT strategies. She seeks to ensure that they fall within the definition of "dealer" under Section 3(a)(5) of the Exchange Act. Any initiative by the SEC on this front will mean grappling with the distinction between "dealer" and "trader" that, according to SEC precedent, is the dividing line for determining whether registration is required. The SEC will need to carefully formulate any such rule, unless it wants to bring certain hedge funds and other active traders under the "dealer" umbrella. And seeking to force all "dealers" to register with FINRA, even exchange market makers and others who do not engage in any customer-facing business, may engender criticism and force smaller HFT players out of the market or underground.

Transparency

Always a focus of SEC rulemaking and a generally laudable goal, Chair White's initiatives on increased transparency might be thought of as directed at best execution. By encouraging greater understanding of trading that occurs in dark markets, broker order routing practices, and dealer profits and costs, new practices will improve the ability of market participants to customize their routing decisions, either generally or for particular trades. Her focus on payment for order flow, excessive intermediation by dealers, and similar arrangements will also contribute to competition among market centers, both lit and dark, on execution quality, rather than attracting orders with payments or rebates or multiple order types. Of course, the newly regulated dealers will need to adjust their business models to comply with these requirements.

CONCLUSION

It is hard to say whether these two speeches signal the start of dramatic changes to equity market structure. Clearly, Chair White has studied the issues facing the markets and presented a series of thoughtful ideas with the trends discussed above. Notably, she also mentions that the SEC will "consider whether more fundamental changes are needed," including an evaluation of the effectiveness of various parts of Regulation NMS. If this review of Reg NMS turns into the fourth trend from the Chair's speeches, we could see significant changes to market structure during her tenure.

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Please do not hesitate to contact us with any questions.

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