# OVERSIGHT OF THE SEC'S DIVISION OF TRADING AND MARKETS

## HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

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# OVERSIGHT OF THE SEC'S DIVISION OF TRADING AND MARKETS

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**Thursday, June 26, 2014**

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 9:19 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Neugebauer, Huizenga, Mulvaney, Ross, Wagner, Messer; Maloney, Lynch, Perlmutter, Scott, Himes, Foster, Carney, and Sewell.

Ex officio present: Representative Waters.

Chairman GARRETT. Good morning.

Today's hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee is hereby called to order. Today's hearing is entitled, "Oversight of the SEC's Division of Trading and Markets." And I welcome the panel. After looking yesterday where it was an elongated two-panel hearing, I welcome our one witness, Mr. Luparello, to the Capital Markets Subcommittee hearing today, and I look forward to your testimony.

We will begin with opening statements. And I recognize myself for 6 minutes.

Today's hearing will focus on the activities of the Division of Trading and Markets of the Securities and Exchange Commission.

Director Luparello, welcome, and thank you for your testimony that you provided in writing and the testimony that you are going to present today.

The Division of Trading and Markets at the SEC, as you know, has a broad swath of responsibility and authority over activities that represent some of the core functions of the U.S. capital markets.

Specifically, the Division sits at the epicenter, if you will, of our Nation's equity, fixed-income, and derivatives marketplaces.

The SEC is reforming or considering reforms of all three of those markets. These changes will dramatically change the way that investors invest, issuers raise capital, and businesses hedge their risk.

First, let's look at the equity markets. Let me thank you again for participating in the roundtable that we held, I guess a little over a year ago up in New York City.

The roundtable, as you know, served as a substantive starting point for Members and other attendees to learn about the evolution of the rules governing equity markets today.

I think it was a very informative discussion we had there and provided a solid foundation from which to better comprehend the current challenges faced by the various market participants as well as the potential impact rule changes could have.

And to that end, by the way, Chair White gave a speech recently where she outlined a number of prospective changes to various market practices in an attempt to address some of the issues most frequently highlighted as concerns.

And so, when she did that, I applauded her, and I continue to applaud her for her continued focus on our Nation's equity markets.

But I caution that moving too quickly or in an ad hoc manner without thinking through all of the possible consequences could, as I say, do more harm than good.

It is so critical, then, that besides just addressing specific narrow issues being faced by market participants, that the Commission conduct a fundamental review and challenge many of the central assumptions regarding the rationale of its overall regulatory regime.

Let me provide perhaps two specifics areas where I would like to see more attention from the Commission.

First, the world is vastly different, we all agree, from 1975, when Congress amended the Exchange Act in response to one dominant equities exchange at the time.

We live in a world of demutualized exchanges where all market centers are for-profit, providing similar functions, yet they are competing under very different regulatory umbrellas.

The SEC should take the time, therefore, to thoroughly analyze the situation and eventually make changes that put these varying market participants on, as I always say, a more level playing field.

Second, Reg NMS, as the order protection rule, is a very heavy-handed rule dictating explicitly how venues and orders are supposed to interact with each other in the marketplace.

Now, this has been highlighted by a number of the commentators, including some of our previous panelists here, as one of the significant factors underlining market practices and, also, behavior.

So I look forward to discussing these issues, as well as Chair White's recent proposals, during the questioning period that we will have after the testimony.

Next, in regard to fixed income, many argue that this is often a part of the marketplace that is overlooked compared to the equity markets.

Our corporate and municipal bond markets have literally trillions of dollars of outstanding issuances, and they provide investment opportunities for millions of investors, but these markets are very different than our equity markets.

Chair White gave a speech on Friday outlining some proposals seeking additional practices and price transparency for investors in these less liquid markets than the equity markets.

So I believe increasing transparency and competition for the benefit of the investors is appropriate, and I'm interested to see more specifics on how these new proposals that she is talking about will actually work.

All that said, I do worry that the Commission's reform potentially robs from Peter to pay Paul, as they say. Specifically, how do we help investors in the corporate bond market if we improve pricing transparency, on the one hand, but if we reduce liquidity through the Volcker Rule, on the other hand?

Requiring additional transparency for markets that the Commission made less liquid and where investors have to pay wider spreads is not a net win for the investors at the end of the day.

A greater investor protection in this market would be to ensure greater liquidity and better ways for investors to get in and out of the positions. That is what liquidity is about.

The SEC then needs to closely examine on an ongoing basis the impact of the Volcker Rule on the liquidity in the corporate bond market and keep policymakers well-informed of this important information.

Finally, regarding derivatives, the Commission took a very important step yesterday in finalizing rules that specify how market participants that have affiliates overseas will be impacted under the SEC's Title VII regime.

So I applaud the rigorous and thoughtful process that the Commission undertook when finalizing those rules, and I am also hopeful that the new leadership over at the CFTC, some of which we just swore in the other day, will allow this process to go forward and to follow suit and formalize their guidance which they have had in the past under a rule now so that the force of law will not be in question.

Finally, another issue that has continued to be one of much debate is the proper regulatory approach for broker-dealers.

Recently, one of the Commissioners gave a speech essentially saying that the SEC is now a systemic risk regulator, and that statement caught us by surprise.

It is my understanding that Congress created the SEC as a markets regulator with three-part function of: protecting the investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.

I served on the Dodd-Frank Act conference committee, and nowhere in that do I recall the mission of the SEC actually changing to a systemic risk regulator.

So I am very concerned that the Division of Trading and Markets actually might be losing one of its primary responsibilities, which is oversight of broker-dealers.

It appears that the Federal Reserve—without any proper authority whatsoever from Congress, what they are trying to spread is a regulatory and bailout net over even the broader marketplace and over the broker-dealer community as well.

So we must stop enlarging the government's safety net and, instead, remove moral hazard and reinstate market discipline.

The Division of Trading and Markets has many important tasks at hand. Other issues that I have not gone into in detail, but are nonetheless important, are: regulating clearing agencies and transfer agents; overseeing FINRA and other SROs; determining whether or not to change the duty of care for broker-dealers; and conducting oversight of the out-of-control and anti-investor Security Investor Protection Corporation.

So, Director, thank you for taking on this very difficult assignment and also for being here today. This subcommittee wants to make sure we work closely with you in the future and also with Chair White and the rest of the Commission as well as you carry out your important duties.

With that, I now recognize the ranking member of the subcommittee, the gentlelady from New York, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. Thank you, Chairman Garrett, for holding this very important and timely hearing.

And welcome, Mr. Luparello.

Mr. Luparello also participated in your meeting on trading and markets that you held in New York earlier, which was tremendously informative and a fine experience for all of us who were fortunate enough to attend.

The SEC has a critical role in our economy because it is responsible for overseeing and regulating the Nation's capital markets.

Without vibrant capital markets, companies would have a difficult time raising money to expand their businesses and create jobs, and our economy would be stalled.

The SEC's mission is to simultaneously protect investors, encourage capital formation by businesses that are seeking to grow, and maintain fair, orderly, and efficient markets.

Balancing these overlapping objectives is a difficult job, but I believe the SEC has performed admirably under Chair White, who, incidentally, is from the great City of New York.

And I look forward to hearing your testimony as well.

There is, however, one common theme that runs through each of the SEC's three missions. In order to accomplish any of the SEC's three missions, investors have to feel confident in the fairness and integrity of our capital markets.

If they are not confident that they will get a fair shake, they will not put their money at risk in our capital markets and they will not invest in U.S. companies.

I have always said that markets run more on confidence than on capital, and I believe that is particularly important right now.

Over the past decade, the incredible advances in technology, along with major overhauls of the regulatory framework for trading stocks, has fundamentally changed our equity market structure.

Some market participants have seen some huge benefits from these changes, particularly retail investors. They have seen their trading costs fall to some of the lowest levels on record.

And other market participants have not fared as well. The lower trading costs for retail investors has come at the expense of certain brokers and intermediaries. This is all to be expected.

Any fundamental overhaul of our market structures has winners and losers, but these changes in our market structure have at the very least caused many market participants to take a step back and question whether they are still getting a fair shake.

That is why I think confidence is so important right now. If there are problems, we need to fix them, because investors' confidence can disappear in the blink of an eye.

I was pleased to hear Chair White say in our April hearing in response, really, to the chairman's question that the U.S. stock market is not, in fact, rigged, as some have claimed.

And I will say that almost all of the market participants that I speak to have expressed tremendous appreciation for the SEC's careful, data-driven approach to market structure issues.

I was also pleased to see that just last night, the SEC announced a pilot program that will test whether wider tick sizes will increase capital formation for smaller companies.

This committee passed unanimously a bill last November that required the SEC to conduct such a pilot program, and that passed the House overwhelmingly.

So I am pleased to see that the SEC has shown a willingness to work with this committee on these important and other very complex market structure issues.

I look forward to working with our witness, Mr. Luparello, who recently took over as the Director of the SEC's Division of Trading and Markets.

Even though he has only been on the job for a few short months, his Division has already announced several major initiatives, and I look forward to hearing from him today.

Thank you very much. And I yield back the balance of my time.

Chairman GARRETT. The gentlelady yields back. Thank you very much.

We now turn to the vice chairman of the subcommittee, Mr. Hurt, for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman. And thank you for holding today's hearing to conduct oversight over the SEC's Division of Trading and Markets.

While the SEC's Division of Trading and Markets has a number of consequential initiatives on its agenda, including the review of our equity market structure, I am particularly interested in hearing about issues related to the self-regulatory organizations.

I am encouraged by SEC Chair White's recent comments that the Commission's review of equity market structure will include an examination of the nature of our self-regulatory model.

However, some, including SEC Commissioner Gallagher, suggested that over time SROs have changed dramatically from self-regulatory to quasi-governmental and now operate more like an additional branch of government.

Congress delegated specific responsibilities to these entities, and they should not be immune from our scrutiny. It is important for this subcommittee to look closely at the current structure of the SROs, their role in our financial regulatory system, whether their operations are sufficiently transparent and accountable, and finally, if changes are necessary to ensure that they meet the standards and responsibilities imposed by Congress.

I am pleased to see several of the SROs implementing more robust processes for economic analysis in their rulemaking.

It is incumbent upon the SEC and Congress to ensure that these cost-benefit standards are rigorously applied. Congress and the SEC should also promote similar policies for the remaining SROs, instead of a reliance on ad hoc measures.

I look forward to working with my colleagues on this subcommittee to critically examine the SROs in our framework of self-regulation in financial markets today.

I want to thank Mr. Luparello for appearing before our subcommittee. I look forward to your testimony.

And thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. I thank the gentleman. And the gentleman yields back.

We will go to Mr. Lynch now for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

And thank you, Ranking Member Maloney.

And welcome, Director Luparello.

Mr. Luparello, you are at the helm of the Securities and Exchange Commission's Division of Trading and Markets at a time of great importance.

Currently, our capital markets face many challenges, including, most importantly, I think, high-frequency trading, a subset of algorithmic trading, and you have mentioned that extensively in your written remarks.

The rise of algorithmic trading, whereby computer algorithms make trading decisions, creates both new opportunities and challenges for U.S. investors and regulators.

As highlighted in Michael Lewis' book, "Flash Boys," advancements in the speed of information are allowing high-frequency traders to front-run trades and exploit market fragmentation for profit without providing socially useful intermediation between investment capital and the companies who can put that capital to use.

Now, I am not sure if using the term "rigged" is proper, that our markets are rigged, but I do know that there are two firms: Virtu Financial, which traded heavily in the market for 5 years without a losing day, which is incredible; and Tradebot, which traded for over 4 years without a losing day in the market.

So maybe "rigged" isn't the proper term, but let's just say the current structure of the market favors high-frequency traders over average investors. And maybe that is why we are seeing a lot of investors walk away from the market, because they believe it is rigged.

I, along with many of my colleagues in Congress, am particularly concerned about abuses in the markets caused by this practice.

Both the Senate Banking Committee and the Senate Permanent Subcommittee on Investigations recently held hearings to examine disruptions in the market caused by high-frequency trading. And I think this committee could do the same.

In a recent speech, SEC Chair Mary Jo White addressed the public's growing concern about high-frequency trading and proposed recommendations for new rules.

I would like to hear your thoughts today about how that might be accomplished.

Thank you for the time, Mr. Chairman, and your indulgence. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Foster is recognized for 3 minutes.

Mr. FOSTER. Thank you, Chairman Garrett. I appreciate your holding this hearing.

Mr. Luparello, I appreciate your appearing before this committee to discuss the complex and important issues around market structure.

I believe it is easy to make the case that technology has largely benefited retail investors who have seen spreads between bid and ask prices narrow to historically low levels.

Ironically, one of the main challenges in market structure is protecting the interests of large institutional investors who are sophisticated participants and are normally thought of as being fully capable of taking care of themselves.

One analogy that I like to use when thinking about high-frequency trading and dark pools is the example of Disney World. Forty years ago, Disney Corporation bought up large blocks of swampland in central Florida using anonymous shell corporations and paying the current market price. Was that fair?

If Disney had attempted this in a State where the prices and beneficial owners behind real estate transactions were immediately made public, then land speculators would have jumped in, buying up parcels of land nearby with the intent of selling them back to Disney at a profit. Would that have been fair?

The point I am trying to illustrate is that while dark pools sound bad to the public because of the implication of opacity, forcing every transaction into the open would create winners and losers.

I agree with Chair White that our equities markets are not rigged. But it is clear that, with 11 exchanges and 40 alternative trading systems, the market is overly fractured and there is a lack of transparency in many respects.

This competition helps keep trading fees low for investors, but it also incentivizes routing two exchanges that pay the most for their orders.

It is also clear that many of the current market regulations were developed in a world before the equity markets were dominated by computer algorithms.

And, yet, it is absolutely clear that not enough information is provided to market participants to know about how their trades are routed and executed.

Additional measures should be taken to ensure that alternative trading systems disclose harmonized digestible information about how they operate and whether or not they are really offering price improvements from the lit market.

So as you embark on a comprehensive review of our equity market structure, including issues like order times and consolidated data feeds, I urge you to use a data-driven approach to bring about more transparency. Market forces and transparencies are often the best disinfectant.

Thank you. I yield back.

Chairman GARRETT. Thank you.

And the gentleman yields back.

We will now turn to our witness. Mr. Stephen Luparello is the Director of the Division of Trading and Markets at the U.S. Securities and Exchange Commission. Mr. Luparello, we can now turn to you, finally, and hear your testimony.

There are two things I always say: one is to make sure you bring the microphone close enough to you because we can't hear otherwise; and, of course, your entire written testimony will be made a part of the record.

You are now recognized for 5 minutes, Mr. Luparello, and thank you for being with us.

**STATEMENT OF THE HONORABLE STEPHEN LUPARELLO, DIRECTOR, DIVISION OF TRADING AND MARKETS, U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. LUPARELLO. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for inviting me to testify on behalf of the U.S. Securities and Exchange Commission regarding the Division of Trading and Markets' activities and responsibilities.

The mission of the Division is to support the Commission's mandate by fostering investor protection and establishing and maintaining standards for fair, orderly, and efficient markets.

To this end, the Division is responsible for the rules that apply to many of the major participants in the U.S. securities markets. We also oversee the rulemaking activities of the exchanges, clearing agencies, and FINRA in their capacity as self-regulatory organizations; monitor risks at large broker-dealers and clearing agencies; and assist the Commission with major international regulatory coordination efforts.

Under the Dodd-Frank and JOBS Acts, the Division has primary responsibility for more than 30 separate mandatory rulemaking initiatives and studies under the two statutes, as well as the ongoing oversight and the implementation they require.

These new responsibilities include the creation of a regulatory structure for securities-based swaps, the regulation and monitoring of clearing agencies designated as systemically important, the prohibition of proprietary trading by insured depository institutions and their affiliates as part of the Volcker Rule, and the development of rules for intermediaries engaged in crowdfunding.

Although the Division's day-to-day and long-term focus cover a wider set of initiatives and mandates, I want to highlight a few of the key areas of responsibility and summarize our current efforts in each.

First, the Division is playing a lead role in the comprehensive review of equity market structure recently described by Chair White to ensure that the U.S. equities markets remain the strongest in the world.

This initiative includes a review of the evolution of market practices over the last decade and the role of Commission rules, including Regulation NMS, in that evolution and the need for any adjustments to that structure.

Chair White has directed the Division to take a number of specific actions related to high-frequency trading, market transparency, and order handling, and has recommended that the Commission create a Market Structure Advisory Committee to review specific initiatives and rule proposals.

Beyond this, the Division is working with FINRA and the exchanges to advance several initiatives, including efforts to minimize consolidated data latency and enhanced transparency and the extent to which such latency exists, clarify how exchanges themselves use data feeds for regulatory and routing purposes, and review order types offered by the exchanges to clarify their operation.

Another important part of the review is developing recommendations to improve the market for smaller issuers, as a core guiding principle of our review is the recognition that, when considering market structure, one size certainly does not fit all.

To this end, the Commission is continuing its evaluation of decimalization rules, including its consideration of a tick-size pilot that would widen the quoting and trading increment for certain smaller company securities and exploring other competitive market structure alternatives for smaller cap issuers.

In addition, last year, at Chair White's request, each of the exchanges, FINRA, and the clearing agencies prepared action plans to strengthen critical market infrastructure.

These entities currently are working to implement these plans, including through several important measures that should be completed in the very near future.

Additionally, in March 2013, the Commission proposed Reg SCI to improve the Commission's oversight of market infrastructure.

As proposed, the rule would require exchanges, clearing agencies, and other critical market participants to have in place policies and procedures reasonably designed to help ensure that their systems are robust, secure, and compliant.

Beyond the many important market initiatives, the Division is working to fulfill the Dodd-Frank Act Title VII mandate to establish a new regulatory regime for security-based swaps, which historically have traded over-the-counter.

These rules are intended to achieve a number of goals, including facilitating the centralized clearing of swaps with the intent of reducing counterparty risk, increasing transparency for regulators and market participants, and addressing capital and margin requirements for security-based swap dealers and major security-based swap participants.

To date, the Commission has proposed all of the rules required by Title VII, adopted a number of final rules and interpretations, and provided a road map for the further implementation of its Title VII rulemaking, and has taken other actions to provide legal certainty to market participants during the implementation process.

Just yesterday, the Commission adopted rules regarding the application of Title VII to cross-border activity. Division staff continues to work to develop recommendations for final rules required by Title VII and has been actively engaged in discussions with domestic and foreign regulators regarding the direction and coordination of international derivatives regulation.

The Division is also continuing its efforts to establish rules pursuant to Title VIII of the Dodd-Frank Act, which requires the Commission to increase regulation of financial market utilities and financial institutions engaged in payment clearing and settlement activities that are designated as systemically important.

Finally, the Division and other SEC staff are considering how to recommend the Commission use its authority under the Dodd-Frank Act to adopt rules establishing a uniform fiduciary standard for conduct for broker-dealers and investment advisors when providing personalized investment advice about securities to retail customers.

To more fully inform the Commission's decision on this issue, Chair White has directed the Division to work with its colleagues in DERA and the Division of Investment Management to evaluate potential options in light of the information available for the Commission's consideration.

Thank you again for inviting me to discuss the Division's activities and responsibilities, and I look forward to answering your questions.

[The prepared statement of Mr. Luparello can be found on page 36 of the appendix.]

Chairman GARRETT. Thank you very much. We appreciate your testimony.

I now recognize myself for 5 minutes for questions.

I am going to begin with the same question that I asked Chair White: Director, are the markets rigged?

Mr. LUPARELLO. That is an easy question to start with.

No. The markets are not rigged. There are clearly things about the markets that require further attention and perhaps some regulatory response or enhanced transparency, and the Commission and the Division are focused on that. But fundamentally, the markets are fair for investors.

Chairman GARRETT. So when the issue of investor confidence is raised, should investors have confidence in the markets?

Mr. LUPARELLO. I think it is fair to worry about investor confidence, even if you think the markets are not rigged.

The extent to which there is a perception that it is rigged is maybe—it is not as important as whether the markets are actually rigged, but it is obviously a very important thing for the Commission.

So one of the things we have to do in our policymaking is do things that reassure participants in the market that the markets are fundamentally fair to them.

Chairman GARRETT. Okay. This may be a segue; I don't know.

Chair White, just recently, in her speech the other day, touched on some of the proposals that you—one of the proposals was the creation of a market advisory committee. And I presume such an advisory committee is supposed to serve as a resource, if you will, of information from stakeholders and the like.

And I assume that the purpose of it is to provide that information as you go forward—you and the entire SEC goes forward with the other recommendations that she and you are considering. Is that correct?

Mr. LUPARELLO. That is correct.

Chairman GARRETT. And she didn't really elaborate. She just spoke one or two sentences in her speech.

So is this advisory committee being put together by her or is this being put together by the entire Commission? How does that work? Maybe you could flesh it out, if you will, a little bit.

Mr. LUPARELLO. I will flesh it out to the extent I can.

Chairman GARRETT. Okay.

Mr. LUPARELLO. The committee will be a committee that will be consistent with the obligations of the Federal Advisory Committee Act.

Chairman GARRETT. Okay.

Mr. LUPARELLO. At this point, the staff is presenting a recommendation to the entire Commission, which will include the mandate, the charter, and the proposed participants.

Chairman GARRETT. Okay.

Mr. LUPARELLO. And, to that point, the entire Commission will have an opportunity to vote on the—

Chairman GARRETT. So, where do the people come from? Who makes the recommendations to serve on this? Is that from Chair White or is it from the whole Commission?

Mr. LUPARELLO. The recommendations in the first instance will be made by staff—

Chairman GARRETT. By staff.

Mr. LUPARELLO. —on Trading and Markets and others. But, obviously, the Commission will have input into that.

Chairman GARRETT. The Commission.

Mr. LUPARELLO. Yes.

Chairman GARRETT. Okay.

A whole slew of issues are being run through here today.

Other people have raised, and we have talked about in this committee previously, Reg 611, also known as the trade-through rule, as an area some people say needs extensive, thorough review, and other people push away and say not.

One of the people who says that it does need further review is Andy Kessler, in a recent Wall Street Journal piece—I remember reading that the other day—and across the Chamber, Senator John McCain. In his opening statement at the Permanent Subcommittee on Investigation hearing on market structure, he also said it does.

What is your take on this? Is this an area that is going to be one of the primary focuses of the SEC for review?

Mr. LUPARELLO. The Chair, in her speech, laid out what I think you can basically categorize as short-term initiatives and longer-term initiatives.

Chairman GARRETT. Okay.

Mr. LUPARELLO. Clearly, the study of Reg NMS, broadly, but specifically the issue of the trade-through rule is one that is very much on our agenda.

Unlike the shorter-term issues, I think the staff tends to think that there is more study and more discussion that needs to go on. There are obviously some benefits that have come with Reg 611 in terms of competition.

Obviously, there is also a substantial amount of fragmentation that has come with it. That is a very difficult issue to balance.

Chairman GARRETT. Yes.

Mr. LUPARELLO. It is very much on our agenda, but at this point I don't think we have reached a conclusion.

Chairman GARRETT. Okay. So one other question. I have 50 seconds here to go.

There is an issue about dealing with best execution and whether you are enforcing and modernizing that whole system. Right?

And also tied to that is the issue of disclosure requirements on that. So there is an issue there as far—as you do that, whether that has a conflict of interest as far as the broker is concerned.

So, in 26 seconds: first, address that; and second, if you are going to be addressing those couple of issues there and that point, the other issue is: Are you getting into the weeds too much on these specific issues before you do a more holistic analysis of the overall market structure before getting down into trying to fix those pieces of it?

Mr. LUPARELLO. You touched on it perfectly, which is that so many of these issues are fundamentally interrelated.

Chairman GARRETT. Right.

Mr. LUPARELLO. And to try to look at them in a stovepipe means you are probably going to have as many unintended consequences as intended consequences.

Chairman GARRETT. Exactly.

Mr. LUPARELLO. There is a very important sort of overarching analysis of how much best execution drives a variety of things, whether it is the need for the trade-through rule or further disclosure on payment for order flow or things like maker-taker pricing. All of those issues, I think we will look at together.

Again, I think it is important for confidence and, because of a variety of smaller fixes, that we move quickly on the shorter-term initiatives.

But we will, on the longer-term initiatives, look at all these things together and not attempt to sort of pick them apart in ways that are artificial.

Chairman GARRETT. Good luck. I appreciate that.

The gentlelady from New York is now recognized for 5 minutes.

Mrs. MALONEY. Thank you very much.

The chairman started with his first question to Chair White. I am going to begin with mine.

I asked, "Are the markets rigged?" And Chair White said, "Absolutely not." And I said, "Some of my constituents think they are."

So, that goes to the confidence issue. And they think they are because of books that have been written alleging it, statements by people alleging it, and basically, that some people have access to information before other people and that gives them an unfair advantage.

I truly do believe that confidence is an important part of markets, and if people don't have confidence that it's fair and that they have a fair shot, the same shot that anyone else has, it will hurt our markets.

So I am wondering, what could we do to address this concern that some people have? I am sure your office is getting the—my office is getting it. You have to be getting these allegations.

Mr. LUPARELLO. We do. And we obviously take them very seriously. And we are borderline inundated on it. But that is our job.

I think the answer to that is going to be different for different segments of the marketplace. Clearly, at the retail end, there is a lot that is good and works well for the market.

By all available metrics, retail investors are doing better now than they have ever done in the past. That is mostly driven, obviously, by technology.

But there are certain things that lead to confidence concerns. One of those is stories around the different access to information.

We are working with the exchanges and the SIPs to make sure that everything is being done to deal with the issue of SIP data latency, for example.

And we are doing things around order types—

Mrs. MALONEY. Dealing with—pardon me—what? Entry?

Mr. LUPARELLO. I'm sorry. Data latency.

Mrs. MALONEY. Data latency. I see.

Mr. LUPARELLO. So doing a variety of things that reinforce fundamental fairness of the market is going to be our first step.

Institutions have different issues and concerns around whether the market works well for them, and part of that is around some level of transparency of what happens in dark pools.

And we are going to pursue an initiative that deals with greater transparency of routing of institutional orders. That exists on the retail side.

It is also worth looking at this time whether that rule, which has been in place for 10 or 12 years, could use some modernization.

But there are a variety of things we can do to bring transparency to the market and attempt to communicate well to retail investors about the fundamental fairness in the market.

Mrs. MALONEY. In Chair White's speech earlier this month, she said she was directing the staff to develop an "anti-disruptive trading rule."

And the purpose of this rule, according to her statement that day, is to limit the use of "aggressive destabilizing trading strategies in vulnerable market conditions."

Can you walk us through what you would consider to be an "aggressive short-term trading strategy?"

Mr. LUPARELLO. I can at a high level. The specifics of that rule are still a topic of conversation and in development.

But, as is generally thought, there are three types of strategies that together form what people think of as high-frequency trading, and there is a lot of gray area around those margins. So, I don't like to get too invested in it.

Mrs. MALONEY. What is an aggressive short-term trading strategy that she is talking about?

Mr. LUPARELLO. One of the strategies is when a trader, based on a signal, aggressively takes liquidity on the same side of the market at multiple times and it is—as compared to a market-making strategy, where you are more passive and providing liquidity on both sides. This is a strategy that sees weakness on either the bid side or the offer side and takes liquidity in sequence.

What the Chair was talking about was developing a rule where, whether or not that's illegal now—and I think, in most cases, we would all agree that it is not illegal—whether there are times when the market is vulnerable and subject to volatility that you restrict a subset of traders from executing strategies like that during short periods of time.

That writ large is what the anti-disruptive trading rule would look like.

Mrs. MALONEY. How would you distinguish between an aggressive trading strategy and the more legitimate trading strategies that major institutional investors and retailers follow? Do you differentiate based on the type of investor or based on the market conditions? How do you differentiate?

Mr. LUPARELLO. Those are very important details.

In our early thinking, I think it is based on a strategy in a very short period of time that is liquidity taking on one side of the market when the market itself is somewhat fragile, all those terms still to be defined.

Mrs. MALONEY. My time has expired.

Chairman GARRETT. Thank you. Good question.

The vice chairman of the subcommittee, the gentleman from Virginia, Mr. Hurt, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

And, again, I thank Mr. Luparello for appearing today.

As we undertake a review of the equity market structure in this country, I wanted to talk a little bit about the self-regulatory organizations generally. Obviously, they play an important role, a rulemaking role.

I am a member of the Virginia State Bar and, as an attorney, as a member of a State regulatory organization charged with the creation of rules as well as the enforcement of those rules, I certainly understand the virtues of SROs generally.

But I want to talk to you about your view on the evolution of SROs. Are they making good rules? Are they going through rigorous analysis to reach those rules? And what about transparency and accountability?

Clearly, those are issues that I think promote the—certainly the response—promote the things that the SEC should be worried about: transparency; capital formation; and investor protection. And so, they play a critical role there.

Can you talk a little bit about that evolution and where they are now and where you could see room for improvement?

Mr. LUPARELLO. Absolutely. And when talking about SROs, clearly there are—the exchanges are also self-regulatory organizations.

It is a very important issue, one that we are looking at more long-term. Your question is, I think, more specifically pointed at the broader rulemaking SROs, specifically FINRA and the Municipal Securities Rulemaking Board (MSRB).

I think all of those points are extraordinarily important both in terms of the ability to have input into the rulemaking process as well as ensuring a level of confidence about that rulemaking process.

Both FINRA and the MSRB, on significant rulemakings over the past few years, have added layers of opportunities for comment.

So, as a general matter, when they are doing rules, first they subject them to their own internal notice and comment process.

And then, after that, if there are major tweaks, they sometimes repeat that process and then eventually come to the Commission, where it goes through a separate notice-and-comment process.

So we are comfortable with that level. One of the things is there is no specific obligation on the SROs to have that internal notice-and-comment process.

I think they tend to think it improves the quality of their product and so are committed to it. But that is one of the things that I think we would like to stay vigilant on and make sure they stay committed to that.

They have also—and this is a fairly recent development—embraced more careful, more specific cost-benefit analysis in their rulemaking. I think that is something that, backsliding, I think we would think would be a very bad idea.

I think, having spent a decent amount of time at FINRA, I always feel the need a little bit to defend the quality of the rulemaking process.

And that early round of communications through notice and comment, as well as going through the committee process, often had a very, very strong cost-benefit component.

And so, I would like to think that most of the rulemaking, even without an explicit cost-benefit obligation, had gone through some fairly careful cost-benefit analysis. That said, making that routinized and making that obligatory is, I think, a fundamentally good idea.

When we at the Commission get rule filings from MSRB and FINRA, the two most important things were, obviously, we want to make sure it is good public policy, but we also want to make sure it is consistent with their statutory obligations and it does pass cost-benefit muster.

Mr. HURT. Talk a little about the role of the SEC.

Do you think the SEC conducts robust oversight over these agencies? And is there room for improvement there?

Mr. LUPARELLO. The oversight of the SROs is the responsibility of our Office of Compliance Inspections and Examinations (OCIE).

So I am a little bit more comfortable talking about being the overseen as opposed to the overseer. But there are substantial resources that are committed to overseeing the SROs.

One of the things that came out of the Dodd-Frank Act was an obligation on the Commission to have a more routine oversight structure with the securities associations, of which FINRA is the only one I know that exists and is robust.

And, look, especially FINRA has a very broad mandate, a very complicated program, and increasing the touch points and paying attention to it is something that you have to do basically all the time because there are just so many different moving parts.

But I know both the Commission, again through the OCIE Staff, as well as the folks at FINRA, are very committed to that ongoing relationship.

Mr. HURT. I see my time is about to expire, so I will yield back the balance of it.

Thank you, sir.

Chairman GARRETT. The gentleman yields back 7 seconds.

And I now recognize the gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman, and Ranking Member Maloney. I appreciate the opportunity to join with you today on the issues that you have identified dealing with the SEC.

I have an issue that is very important to me that I have been trying to advance. I have a bill, H.R. 1627, the Investment Adviser Examination Improvement Act, which would authorize the SEC to levy user fees to cover the costs of an increase in the frequency of examinations of investment advisers.

The Investment Advisory Committee of the Commission has endorsed this legislation, which is one of the recommendations that SEC staff originally provided in the study required in Section 914 of Dodd-Frank.

From your perspective, do user fees represent a scaleable and workable way for the Commission to improve investor protection?

Mr. LUPARELLO. I think, at a high level, the Chair and the Commission, as well as the staff, remain very concerned about the coverage of investment advisors from an examination standpoint, especially as compared to broker-dealers, and those statistics are well-known.

We continue to be supportive of any solution that allows for a greater coverage of investment investors that is, frankly, consistent with the statute.

Ms. WATERS. Section 911 of the Dodd-Frank Act provides that each time the Investor Advisory Committee submits a finding or recommendation to the Commission, the SEC shall promptly issue a public statement assessing the finding or recommendation of the committee and disclosing the action, if any, it intends to take with respect to the recommendation.

Does the Commission plan on responding to this recommendation from the Investor Advisory Commission?

Mr. LUPARELLO. Congresswoman, I am afraid that is an area of the Commission's responsibility, specifically the Division of Investment Management, that is outside my scope, and I can't speak to it. I'm sorry. I can find out the answer, though.

Ms. WATERS. All right. Let me just wrap this up, Mr. Chairman, by saying that the examinations are done for the investor advisors once every 12 years.

That is all they can expect to have to respond to in terms of an examination, which means only 8 percent of the exams are being done.

And so, this is a very important issue, and I am hopeful that everything possible can be done to continue to advance it.

And if user fees probably are the only way that we can get the resources to do the examinations, of course, I am hoping that everyone will support the idea of user fees.

Mr. LUPARELLO. I couldn't agree more with your observation.

Ms. WATERS. Thank you. I yield back the balance of my time.

Chairman GARRETT. Thank you.

The gentleman from Texas is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. And thank you for having this important hearing.

Mr. Luparello, in a recent speech Commissioner Gallagher had an interesting observation. He stated that when people ask him how the SEC should respond to Michael Lewis' "Flash Boys," which focuses, as you know, on striking, tells about the high-frequency trading in equities, his response is, we still need to respond to Lewis' 1989 classic, "Liar's Poker," which is a vivid description of the bond market structure issues that are still present today.

I agree with him. That scenario is one we haven't really looked at in the past.

And when I look at the allocation of resources at the SEC, you have hundreds of staffers in your division that are devoted to oversight of the equity and options market.

And I believe there are six employees in the Office of Municipal Securities and, amazingly, no staffers focused on the corporate bond market.

Given that debt financing is nearly $15 trillion of the market, why has the SEC allocated such a small amount of its resources to those markets?

Mr. LUPARELLO. Overall, I entirely share your concern and support Commissioner Gallagher's observation. Let me just correct you every so slightly.

While Trading and Markets does not have a subsection that is solely focused on the fixed-income market, specifically, the corporate fixed-income market, there are a number of people for whom that is their responsibility.

But overall, I couldn't agree more. Obviously, we have a lot of work to do on equity market structure. We also have a lot of work to do creating a market structure for over-the-counter derivatives.

But fixed-income, especially given how investing appetites are going to change going forward, is only going to become more and more of a retail market and more and more worthy of our interest and investigation.

The Chair did give a speech within the past few days where she outlined at least some preliminary thoughts on how to address market structure in the fixed-income space. That work is going to come out of my division, and it is something we take very seriously.

Mr. NEUGEBAUER. I think I have heard people say that there is probably less efficiency in the bond markets than in the equity markets.

Would you agree with that statement?

Mr. LUPARELLO. Yes, 100 percent.

Mr. NEUGEBAUER. Yes.

So somebody is paying for inefficiency?

Mr. LUPARELLO. Part of that inefficiency comes with the fact that it is just fundamentally a less liquid market. But there is certainly some transparency that we would like to explore bringing to that market.

Mr. NEUGEBAUER. Turning to the Volcker Rule, in, I think, October of 2011 and January of 2012, the agencies received nearly 18,000 comments voicing opinions on a rule and, at the prodding of the White House and the Treasury Department, the rule was completed at the end of last year.

Now, a lot of us felt like the initial rule that was put out was pretty vague, which prompted a lot of questions about it.

And then, when the rule came back out, a lot of us were hoping that it would be re-proposed and be opened back up for comment, but that was not the case.

And so, I think the industry felt like they were left with a lot of unanswered questions, and there continues to be, as I'm am sure you are aware, a growing number of concerns about the enforcement and how the rule is going to be interpreted.

So tell me kind of, what the game plan is here. You have the Volcker Rule working group. But how are people going to have the opportunity to respond to those in a timely manner? And have you worked out who makes the final decision where you have a multi-agency Commission here looking over that process?

Mr. LUPARELLO. Obviously, coordination is important. And the working group, which has representatives from the five regulatory agencies, meets constantly and is committed to consistency.

One would hope that commitment to consistency doesn't come with a cost of being slow in terms of getting guidance out, and my observation in my short time there is that has not been the case.

So, as I said, the agencies are committed to doing these things completely consistently.

We have started putting out responses to frequently asked questions. Three additional ones went up within the past couple of weeks. I think there are six now. Our view obviously is that is a living document that we will continue to try to populate to the greatest extent possible.

Also, in our examination programs we are reaching out and having those conversations to try to get additional questions from entities that will be covered by the Volcker Rule so we can give them as much guidance as we possibly can. The extension of the conformance date also gives us a little bit more of a window to get that done.

Mr. NEUGEBAUER. So are these interpretations—are they being made public so that everybody gets a look at them?

Mr. LUPARELLO. Absolutely.

Mr. NEUGEBAUER. And what about the minutes of the working group and how they are making those decisions and how they are coming to those conclusions? Any transparency there?

Mr. LUPARELLO. Complete transparency on the FAQs that are on our Web site and the Web sites of the other four agencies. I am afraid I don't know the answer to your question.

Chairman GARRETT. The gentleman's time has expired.

We will give a little leeway to the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman.

Mr. Luparello, I want to go back to the speech that Chair Mary Jo White gave back at Sandler O'Neill on June 5, 2014.

She mentioned that the SEC is assessing the extent to which specific elements of the high-frequency trading environment may be working against investors rather than for them. This was about a month ago.

Have we made any progress on that?

Mr. LUPARELLO. The Enforcement Division obviously has a number of—

Mr. LYNCH. Could you pull that microphone closer? My hearing is not good.

Mr. LUPARELLO. Neither is mine. So I apologize. And I could hear you perfectly. I apologize for the microphone being too far away.

Obviously, if the Commission's staff in the Enforcement Division believes that there are market participants who are violating existing rules, that is subject to very careful investigation and enforcement. There have been a small number of cases, but I think, to be perfectly frank, the vast majority of high-frequency trading activity exists inside what is currently considered legal trading.

The Chair brought forward a number of initiatives, all of which are in development, including the one we had spoken about just briefly on the anti-disruptive trading rule being one that is very much directed at the conduct you are looking at.

That is something that is a very high priority for the Division to come up with a recommendation to the Commission in the very near future, but we have not presented that to the Commission yet.

Mr. LYNCH. All right. Thank you.

Let me ask you—she also raised the issue of eliminating the exception right now from FINRA registration for dealers that trade in off-exchange venues.

Are we making any progress on that?

Mr. LUPARELLO. That is actually—that is half of two pieces, the other of which is to clarify that certain market participants that trade at a certain level need to register as broker-dealers.

Then, having clarified that obligation to register as broker-dealers, if they participate in the over-the-counter markets, which clearly most high-frequency traders do because that is where dark pool volume gets reported, they would need to register as FINRA members.

Those proposals are in development. Again, I think we are hoping to get them to the Commission soon.

Mr. LYNCH. She also talked about the volume of trading being done in dark pools versus on lit exchanges and mentioned that there might be some way to put a little bit more light on some of these dark pools.

Are there any concrete steps in that direction?

Mr. LUPARELLO. Specifically, those proposals would call for enhanced transparency in terms of the business operations of ATSs.

It is not so much changing the mix of lit quotes versus dark quotes, but basically the business operations, how they execute orders, how their fees work—

Mr. LYNCH. A lot of dark pools are not ATSs, though.

Mr. LUPARELLO. No. They are ATSs.

Mr. LYNCH. Are you doing anything in that regard?

Mr. LUPARELLO. Yes.

I'm sorry. They are ATSs.

So it would basically be looking back at our ATS rulemaking of 10 or 12 years ago and modernizing it, enhancing the level of disclosure about the business operations of ATSs, including, importantly, the mix of participants in the ATSs and then making that information publicly available.

Again, I feel like I am repeating myself, but that one is also in development.

Mr. LYNCH. No. I understand.

And it sort of leads to—the last question I have is, in her speech the Chair actually brought up a couple of enforcement cases where broker conflicts—because of the maker-taker fee structure, where some brokers were getting enhanced fees if they sent their trades in a certain direction.

There was a conflict there with the general duty to place the best trade for an investor. She had a couple of fraud enforcement actions that she mentioned.

What are we doing in that area to try to manage those conflicts for the brokers?

Mr. LUPARELLO. Maker-taker is a very important issue. It is a very complex issue, one that we have been studying for a while, and will continue to study.

I will say, however, that if a broker is routing his customer orders based only on the desire to obtain rebates or avoid fees without making sure that he is meeting his overarching obligation of best execution, I think that would clearly violate our existing rule set.

Mr. LYNCH. Thank you.

I have exhausted my time. I yield back.

Chairman GARRETT. Thank you.

The gentleman's time has expired.

Mr. Ross is recognized for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Mr. Luparello, in reviewing your opening statement, you talk about providing technical assistance to the Department of Labor with regard to their definition of "fiduciary" and specifically as to the practical application of making sure investors have proper guidance with regard to ERISA.

I have some grave concerns over that.

First of all, it gives rise to a new cause of action. As a lawyer, that is great. As a litigator, it is even better. But I think that it directly and adversely impacts the investors.

Because I think, once you put that standard in there and you have an exodus of broker-dealers from the market, you still have a demand for that advice, and I think you create a more volatile investment market because of it.

And my concerns are: What technical assistance are you providing? And do you feel that there should be a fiduciary definition with regard to investments with ERISA for broker-dealers?

Mr. LUPARELLO. The Chair has asked the staff of Trading and Markets, as well as the staff of Investment Management, to come up with some proposals on that very issue, the standard of care, whether you can continue to have separate standards of care for different distribution venues or whether you need a single standard of care and whether that single standard of care is—

Mr. ROSS. And I think that is appropriate.

I think there also should be a cost-benefit analysis because I think you are going to see, again, an exodus in the market of the broker-dealers. And, I think there are standards of care. There are standards of care just by way of common law.

There is misfeasance, malfeasance, and negligence. And there are errors and omissions policies out there that cover that for some of these professional broker-dealers.

So I am just very concerned that moving in this direction is going to do more harm to the investment market of those who want to engage in it than it will do as a benefit.

Mr. LUPARELLO. I completely agree.

And in developing our recommendations, cost clearly is an issue. We also worry about investor choice.

As for the guidance, the technical assistance we are giving the Department of Labor, that is mostly in terms of providing them our understanding of how the market operates. Obviously, their decision-making process is one over which we don't have any control.

Mr. ROSS. Thank you.

Turning to the Volcker Rule again, the Volcker Rule will take place about the same time as the Basel III capital requirements are going to be imposed—what may very well be—when they may very well be imposed.

My concern—and I want to know if it is a concern of yours—is whether there is going to be an impact on interest rates for corporate borrowers because of Basel III and the Volcker Rule.

Mr. LUPARELLO. Obviously, we are concerned about and carefully look at liquidity in the marketplace. Even if we didn't, the Chair has asked us to provide information on a quarterly basis, I believe, of—

Mr. ROSS. Because that could impact our markets pretty significantly. It might be—

Mr. LUPARELLO. Absolutely. We have—

Mr. ROSS. —a little bit more regulation than we might need there.

With regard to the Volcker Rule and the exemption for municipal and State debt as well as sovereign debt, because these types of investments, these types of debt, if you will, may fluctuate in the market, do you think that there is more advantage to the larger banks to take riskier investments because they will be protected as being exempted from the Volcker Rule?

Mr. LUPARELLO. I will be honest with you, Congressman. It is not an area that I have spent enough time studying to provide an insightful point of view.

Mr. ROSS. But I guess Congress exempted certain debt of State and municipal debt, but then the regulatory environment added sovereign debt.

And that has me concerned because I think that those are gambles that—I don't know how many people want to invest in the City of Detroit right now, but that is an exempted debt under the Volcker Rule.

Let's see. Lastly, the United States remains the only developed country to implement a restriction on proprietary trading.

Will U.S. corporations face higher borrowing costs and be placed at a competitive disadvantage with regard to their foreign counterparts?

Mr. LUPARELLO. Clearly, that is something we plan on studying and plan on continuing to communicate about with this subcommittee.

Mr. ROSS. I appreciate your insight on that.

And I will yield back the balance of my time.

Chairman GARRETT. Thank you.

The gentleman yields back the remainder of his time.

Mr. Perlmutter is recognized for 5 minutes.

Mr. PERLMUTTER. I thank the kinder and gentler chairman for my 5 minutes.

Mr. Luparello, thank you for being here today. I just have kind of a series of questions about different kinds of rules that are out there.

In the lead-up to the crash of 2008, there were a couple of rules that were not in place that I think ultimately were then put back into place, and I would like to know what their status is.

What is the status of naked short sales and the uptick rule? Do those exist or exist in some form or another?

Mr. LUPARELLO. I will look for my staff folks over my shoulder to tap me on the shoulder if I am wrong.

But I understand that the—to the best of my recollection, the short sale rule exists, but it exists only during certain times of market stress. So, the short-sale tick-test rule exists only in narrow instances.

Mr. PERLMUTTER. In sort of times of—

Mr. LUPARELLO. Right.

Mr. PERLMUTTER. —where the market is diving, in effect?

Mr. LUPARELLO. When the market is already directionally going—when it is already directionally going down.

Mr. PERLMUTTER. Okay. Thanks.

Talk to me about—and explain to the committee, if you would, because—this exchange-traded funds and leveraged exchange-traded funds and how those might have an effect on the overall market if things were to go sour.

Mr. LUPARELLO. I think we talk about market structure for equities and we talk about market structure for fixed income and derivatives.

But exchange-traded funds is an enormously important part of the market. It is something that my staff spends a lot of time on, as well as the Division of Investment Management, studying whether there are aspects of that from a market structure standpoint that we need to look at.

There is also obviously—

Mr. PERLMUTTER. So what is an exchange-traded fund?

Mr. LUPARELLO. It is any number of products that either represent a basket of securities or some other reference asset that you can trade intraday. It is basically like a mutual fund except that there is pricing during the day.

There is not always perfect transparency around the components of it. And so, the arbitrage between the components and the ETF are very, very important.

Mr. PERLMUTTER. So in the SEC's sort of overview of these funds and the trading of these funds, what are you seeing today?

Because I have seen kind of an increase in articles about potential problems, one part of the market saying, "No. There is no problem here," others saying, "Well, we had better watch this."

Mr. LUPARELLO. I think, from a market structure standpoint, it is certainly worthy of further attention.

I think we are also always worried about whether some of these products are complex and being sold to investors who don't actually understand the complexity and that they create separate sales practice issues.

That is another part of it to which we need to pay very close attention.

Mr. PERLMUTTER. Can you tell us what the—a couple of years ago, Mr. McHenry sponsored a bill on crowdfunding for small purchasers, small investors.

And there are fears about—part of your job, obviously, is being a policeman, making sure that people aren't taken advantage of, there isn't fraud in the marketplace.

So, you have been tasked with some rulemaking on crowdfunding. What is the status of that?

Mr. LUPARELLO. The proposed rules were published in October of last year, I believe, and we received a number of very thoughtful comments. The staff is working on it.

There are issuer obligations that are embedded in the rulemaking that are the responsibility of the Division of Corporation Finance.

The intermediary obligations, whether that is broker-dealer obligations or funding portal obligations, are our responsibility.

We are working through it to the best of our ability and hope to get a recommendation to the Commission very soon.

Mr. PERLMUTTER. All right. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you.

Mrs. Wagner is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

And I thank Director Luparello for being here.

I want to continue the discussion on the fiduciary standard of conduct and, in your own words, consider whether and, if so—I underscore "if so"—you will adopt rules establishing a uniform standard.

To me, the most critical issue raised by the potential fiduciary rulemaking is whether the new rules will, in fact, hurt low- and moderate- and middle-income individuals' access and affordable financial advice.

And I appreciated your statement to Congressman Ross about the concerns of cost and choice in that investor market.

Dodd-Frank required the SEC, I know, to study whether to subject broker-dealers to a fiduciary standard. However, the SEC's 2011 study "failed to identify whether retail investors are systemically being harmed or disadvantaged under one regulatory regime as compared to the other." This was, of course, according to Commissioners Paredes and Casey.

Without investor harm, Director Luparello, is there any basis to conclude that a uniform standard would, in fact, enhance investor protection?

Mr. LUPARELLO. I think clearly, one needs to identify a benefit to stand up against the cost. The Commission before my time, but in the recent past, put out a request for further information around a variety of these issues. It is something that we continue to study very carefully.

But I think it is a fair question that you need to identify a real benefit before you start to analyze the costs and benefits of these things.

Obviously, there are certain aspects of the fiduciary standard which provide enhanced investor protection. But again, cost and choice are things that have to be balanced against that.

Mrs. WAGNER. And I appreciate that.

Following up on that 2011 study, Chair White, I know, told the committee in 2013 that she would do that request for information to better inform the rulemaking. What were the results of that request for information?

Mr. LUPARELLO. I think, to a certain extent, the level of information that flowed in was less than the staff thought it was going to be.

And so, one of the questions we have is: If we are going to come up with recommendations, will there be a need for a new round of information-gathering?

Mrs. WAGNER. And that was my understanding, that there really was not much feedback there. And I continue to be concerned about, again, this being a solution in search of a problem.

Has any of the information helped inform your thoughts on how—thoughts on this potential rulemaking? And how that would be played out?

Mr. LUPARELLO. Clearly, all input we get is important input. But it is all part of a multifaceted analysis that includes multiple divisions of the Commission.

So, again, any input we can get is going to be helpful input. What the final recommendation is and how much that input is going to drive that is still something that is being—

Mrs. WAGNER. I know that the SEC found in 2008 that investors were somewhat confused about whether they were dealing with broker-dealers or investment advisers. However, they did not identify any specific harm.

Is the only solution to impose a fiduciary standard of care on broker-dealers or could any issues be fixed by, let's say, amending existing FINRA rules?

Mr. LUPARELLO. One of the questions is whether there are enhancements to existing rules for broker-dealers and—as well as recognition of some of the existing rules on broker-dealers that deal specifically with conflicts. That is always an option that I think has to be considered.

Mrs. WAGNER. Good.

One source of confusion for investors might be the variety of titles that brokers and investment advisors use.

Would a simple way to fix the problem be to clarify which titles they can use, sir?

Mr. LUPARELLO. I don't know if that would entirely solve investor confusion.

I can say that years ago, I was involved in a project where there were a variety of titles that were being used, especially around advice to senior citizens, that were, basically, fundamentally baseless.

And so FINRA has in the past attempted, as well as other regulators, to crack down on the misleading use of titles. Whether you get to specificity around the words that can be used and that solves investor confusion is certainly worthy of additional consideration—

Mrs. WAGNER. In my limited time, Chair White recently said the rulemaking was a high priority and she wanted to make a decision this year. So, she asked the staff for options.

What other options have the staff suggested to the Commission?

Mr. LUPARELLO. The development of those options is still in process, but I think you have touched on what the variety of choices could be.

Mrs. WAGNER. And will you be able to report back to us some of those options at some point in time, sir?

Mr. LUPARELLO. I believe I need to report to my Chair, first. But, yes, absolutely.

Mrs. WAGNER. Wonderful. Thank you. I appreciate it.

I yield back, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back.

Mr. Scott is now recognized.

Mr. SCOTT. Thank you very much, Mr. Chairman.

Mr. Luparello, when Securities and Exchange Commission Chair White appeared before our committee, I expressed some concerns about what is referred to as the lack of order competition and I asked her what her plans are to deal with market structure.

And I want to make a note that I am somewhat encouraged by the recent announcements of the items that you intend to take action on before the end of the year. However, it appears that much of this is low-hanging fruit and does not directly address my concerns that I addressed to her about order competition.

So let me ask you: What is your plan to address some of the bigger market structure issues such as the increased level of dark trading that even the SEC has recognized as having a negative impact on price discovery?

Mr. LUPARELLO. I think your characterization of the Chair's plan is fair and, frankly, what she would articulate as well, that there are a variety of initiatives that the staff is ready to move on quickly and that there are others that deserve, frankly, a little bit more study, a little bit more interaction—

Mr. SCOTT. What would be some of those you want to move on quickly?

Mr. LUPARELLO. The ones we would want to move on quickly are an anti-disruptive trading rule, the registration of all high-frequency traders as broker-dealers, the requirement that those that trade over the counter become FINRA members, enhanced disclosures on the business operations of ATSs and enhanced disclosures on the routing of institutional orders.

The issue you touch on is an extraordinarily important one—right?—that there is an extraordinary amount of fragmentation in the marketplace these days, some of which leads to positive competition and lower costs, but some of it clearly can lead to degraded opportunities for lit quoting and for order interaction.

That is a very important balance and one that we desire to get—

Mr. SCOTT. But are you all assessing point by point the negative impacts on price discovery?

Mr. LUPARELLO. Absolutely. So as we study NMS—and, again, I don't want to refer to it as a long-term study—what—our next plan is to put out a series of White Papers, work very closely with a variety of participants, including our Market Structure Advisory Committee, once it is stood up and operational, to look at these issues.

I tend to like to think of that one in the context of the trade-through rule, that a lot of these things come with the fragmentation of those venues.

And so we will look at—we are very much going to look at that. That is one of our most important longer-term issues.

Mr. SCOTT. Okay. Let me share very quickly, this is a rather startling observation. But today, only 63 percent of trades are conducted in what is referred to as lit markets, where we can see them. Now, that means 37 percent are in dark pools. It means that investors are not seeing the true depth of the liquidity behind the stocks.

So while high-frequency traders will, what you refer to, ping the market by sending out a bid to see if there is a response from the dark pools, this is not possible for all investors.

How does this affect an investor's ability to even price a stock? And is this a significant advantage for some participants over others?

Mr. LUPARELLO. It is certainly worthy of study. And I completely agree with the importance of those statistics.

That said, it is probably worth noting that, of that 37 percent, a significant portion are actually retail investors getting good-quality executions very quickly done. That doesn't at all touch on the issue of whether we have quote degradation that we need to worry about.

But one of the things we need to do as we study is to make sure that some of the better features of the markets, including how retail investors experience both high-quality and rapid executions, doesn't get degraded or, frankly, if it does get degraded, it is a decision we are making with our eyes wide open.

So, yes, it is, I think, just sort of troubling on its face that such a large percentage of activity happens off of lit markets and there are more headwinds than there are encouragements to quote in lit markets. But, to a certain extent, that has come to the benefit of certain retail investor-type trades.

It is a very complex issue, one that we plan on studying very carefully.

Mr. SCOTT. Thank you very much.

The lack of order competition is a very, very serious issue.

Mr. LUPARELLO. I could not agree more.

Mr. SCOTT. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The remaining gentleman on our side, Mr. Mulvaney, is now recognized.

Mr. MULVANEY. Thank you, Mr. Chairman.

Mr. Luparello, let's talk a little bit about litigation and liability, which I used to know something about in a previous life.

One of the things that Dodd-Frank did—I think it was Section 921(a)—is give the SEC the ability, but not the obligation, to limit the use of arbitration in securities litigation.

I used to do a little of that. I have been on the plaintiffs' side of that, and I have been on the defendants' side of that. And while it was certainly different than going through the court system—the ordinary court system, I have to tell you that I liked parts of it. It was a lot quicker. It was a lot easier. And for both sides, it was usually a lot cheaper.

I recognize the fact, again, that it was different than going through ordinary litigation. There were certain tools that were not available to me, for example, as a plaintiffs' lawyer, that would be in the courts. But, conversely, it was a trade-off there of having it be easier, quicker, to do.

So, I guess, now that you have this ability to limit—or to possibly limit the use of arbitration, I have to ask you: What's wrong with arbitration? What is the SEC's stance on arbitration within financial securities litigation?

Mr. LUPARELLO. I can't help but sort of flash back a little bit to my extended tenure at FINRA, where we ran the dispute resolution forum and worked very hard to make sure that it worked as efficiently as possible, but felt a certain need to defend the arbitration program as a viable alternative.

Obviously, the statute provides the Commission the authority, but not the obligation, to act. As a general matter, in its oversight capacity, the Commission spends a substantial amount of time with FINRA making sure that forum is run as carefully and fairly and transparently as it possibly can be.

Obviously, there have been a lot of enhancements made to that forum, I think very much to the benefit, over the past few years.

The Commission hasn't particularly—hasn't taken a position on Section 921 at this point, to the best of my knowledge. And while I am relatively new and have had a variety of conversations with the Chair, that is one that I still haven't had.

Mr. MULVANEY. And just to clarify one thing—because I understand a little bit of the history of how it ended up in Dodd-Frank—is it the opinion of the SEC that arbitration contributed to the financial crisis?

Mr. LUPARELLO. Not to my knowledge.

Mr. MULVANEY. Okay. Thank you very much.

Let's talk about a different, but somewhat related, topic, which is the liability of exchanges.

My understanding is that exchanges, when they perform their regulatory functions, have certain immunities from liability; when they perform their commercial functions, they don't.

I think this has become relevant in the last couple of weeks and months as NASDAQ has sought to assert its immunity vis-a-vis the Facebook IPO and that what we might be seeing, is an attempt by certain exchanges to sort of blur the lines, to make that which is commercial appear regulatory in order to avail oneself of immunity from liability.

Has the SEC looked at this issue? I don't think you have expressed any opinions on it yet. Do you expect to do so in the near future?

Mr. LUPARELLO. SRO immunity is a creature of case law and, like any good litigator, one tries to expand that protection based on the facts.

The SRO status of exchanges—and you described the issue perfectly—is the difference between the commercial and the regulatory, and it is certainly on our agenda to do.

I think, when we think about the SRO status of exchanges, we are thinking about two different issues, one of which is the competitive playing field between exchanges and other venues that do things that look an awful lot like exchanges.

But part of it is analyzing the SRO obligations and protections that go with being an SRO that the exchanges currently enjoy.

So that is an issue we are going to continue to look at.

Specifically on the Facebook litigation, to my knowledge, I don't know that we have been asked to opine and I don't know that we—

Mr. MULVANEY. I am not asking you to opine—I used that only as an example.

So I guess my last question is this: Can we expect the SEC to provide some guidance in the near future and say, "This is regulatory and this is commercial?"

Mr. LUPARELLO. Perhaps in the context of studying the SRO issue more broadly, which is one of our longer-term initiatives, that will be something that we opine on.

At this point, I think giving specific guidance is probably not in the near—is not going to happen in the near future.

Mr. MULVANEY. Thank you, Mr. Luparello.

I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Foster is recognized for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman.

One example of the current system for not incentivizing maybe the best behavior is the proliferation of order types that are designed to capture rebates from the exchanges. Reg NMS put in place a uniform, one-size-fits-all, 30-mils fee cap for all stocks.

And this rebate model has arguably increased liquidity for active named stocks, but some would say that it actually made those stocks more costly for institutional investors. It also has perhaps pushed transactions to off-exchange venues as investors try to avoid these fees.

My question is: Is the Commission contemplating—or should it contemplate a pilot program to reduce the market fee access cap, perhaps alongside the tick-size pilot, particularly for very liquid stocks? And specifically, what would you think of tiered access fees based on the liquidity?

Mr. LUPARELLO. I think those are all—first of all, I completely agree with the observations.

Maker-taker in certain areas of the market is definitely tied inextricably to the growth of complex order types. In the short term, we have asked the exchanges to go back and do an inventory of their order types, make sure they understand how all their order types work and how those order types—whether or not those order types are consistent with how they were described to us in the first instance.

We have given them a deadline of November to come back with that study, which, given the complexity in the growth and order types, is a challenge.

Maker-taker and the issue of potential broker conflicts married, of course, to the fact that does, I think, pretty clearly drive a substantial amount of volume from on exchange to off exchange is something that we are going to consider.

I don't know at the end of the day that we will decide to go with a pilot, but I think certainly a pilot is one of the options. And, again, I think the way you articulated it that—and sort of consistent with our notion of one size not fitting all, clearly maker-taker has a different impact at the more liquid end of the market than it does at the less liquid end of the market.

So, I can't say we have reached any conclusions yet. There is a lot of work to do there. But I think the issues that you have articulated are ones that are both very much at top of the book for us, but also somewhat consistent with how we are thinking about it.

Mr. FOSTER. Are there alternatives you are considering in addition to pilot programs? You could obviously just adopt something market-wide, but it seems like it mitigates the risk if it starts with a pilot program.

Mr. LUPARELLO. It is certainly too early to tell in terms of our thinking. And so I will just cite what others have cited, which I think are worthy of further analysis.

Obviously, a maker-taker pilot with trade at the most liquid end of the market.

The other thing is looking at perhaps quoting in subpennies versus quoting in pennies, which would have a natural compression aspect on maker-taker, as well as just considering the consequences of banning it outright.

I think these are all things that we are going to think about over the next few months.

Mr. FOSTER. Are you thinking of changes to the attribution rules?

Basically, it is my understanding that when a trade is made public, the venue is not made public in most or maybe all instances, whereas other countries, in fact, do it differently, where the venue is also made public.

This may allow third parties or the participants themselves a better view of whether you are actually getting the best deals on which venues.

Mr. LUPARELLO. I think that is especially true with dark pools. There still is a fair amount of opacity whether an over-the-counter trade was a dark pool trade versus just an internalized trade of a broker-dealer.

FINRA has made some steps going forward on that to enhance transparency. So you now have a requirement that transactions that are reported by a broker-dealer that sponsors an ATS clarifies whether it is a broker-dealer or whether it is the ATS. That is an important first step.

They are also publishing transaction volume information. It is an important next step.

But one of the interesting things about the over-the-counter market is there is sort of an assumption that the 30-something percent that makes up the over-the-counter market is entirely dark pools. The reality is, it is only about a third in dark pools.

And so, we are going to have conversations with FINRA to continue to try to develop greater transparency in that space, just how much of the over-the-counter activity is happening inside of ATSs versus happening broker-broker versus happening internalized.

And I think one of the next steps off of that is looking at whether attribution of location, hitting the tape as opposed to just hitting the regulatory tape, is something worth pursuing.

Mr. FOSTER. Okay. And, quickly—I guess I have about 15 seconds—do retail investors today have relatively simple tools to get some idea of whether their trades are being executed well or not?

They can see their fees actually, but what about the other part of it?

Mr. LUPARELLO. The information is made available to them through existing Rules 605 and 606, which are Commission rules. Just how usable they are for retail investors is a very good question.

Obviously, they also get disclosures through their confirms. I suspect most investors, if they are trading with their broker, have ready access to what is the inside market at the time and they can evaluate how well they are doing with the inside market. That clearly doesn't tell the entirety of the story, but it does tell some of the story.

We would also hope that broker-dealers in their responsibility to their customers both look out for their customers, but, also, communicate well the quality of those executions. Their ability on a trade-by-trade basis to say, "Is this broker versus this broker going to give me a better deal?" is a very complex analysis.

Mr. FOSTER. Thank you.

I yield back.

Chairman GARRETT. Thank you.

And now, for the last word.

Mr. CARNEY. That must be me, Mr. Chairman.

Chairman GARRETT. The gentleman is recognized.

Mr. CARNEY. Thank you very much, Mr. Chairman. And thank you for having this hearing today. It is very interesting, if not a little bit complex and esoteric, for sure.

I just have a few questions on some of the issues that I have been thinking about and working on over the past couple of years. Mr. Luparello, I appreciate you coming in today and having this conversation with us.

You had some conversation a little bit about the tick-size pilot. I have been working with my colleague on the other side of the aisle, Mr. Duffy, for over a year on that, and we actually passed a bill out of this committee and on to the Floor as well. So, I was happy to see that the SEC is moving forward on that program.

What do you expect to or hope to achieve out of the pilot and the framework that you have come up with?

Mr. LUPARELLO. I, too, am happy that it is out the door. Obviously, there are a couple of procedural—

Mr. CARNEY. By the way, I thought it was very well done. Not that I am an expert at all, but we were really just—our effort was to try to encourage the SEC to do something, and we were pleased with what you did.

Mr. LUPARELLO. I appreciate that.

And in the short term, the issues we want to study most carefully. So there will be a substantial amount of data that the SROs need to push to us to help in our analysis.

But, fundamentally, what we want to see is whether there is more depth at the quotes based on the wider tick size, whether there is greater market-maker participation and, therefore, greater market-maker support.

Obviously, at the same time, we want to see whether the wider tick size causes—certainly, in some cases, it may actually raise investor costs, especially retail investor costs, a little bit. That is an issue we need to pay careful attention to and evaluate.

I will say, while this is an important step forward and something that gives us a real vision into whether there are solutions for a segment of the market that work really well, I would like to think this is not the only thing we plan to do in the lower capitalization area.

Mr. CARNEY. So talk about some of those other things that you think you would like to do. I think some of them were part of what you were just discussing.

But what are some of those things?

Mr. LUPARELLO. A little bit.

But one of our longer—as I have talked about the Chair's speech and the Chair's vision on market structure, there are the shorter-term steps, which are our concrete actions to take, and there are longer-term things to think about.

And in that longer term is just specifically the market structure for lower-cap, lower-volume stocks. And I think—one of the ideas that has been thrown around, one that has garnered a lot of conversation, is things like venture exchanges.

And I think we are very open to the idea of competitive solutions. That is based—and we will continue to work with a variety of market participants.

Mr. CARNEY. Sounds good. I am glad to hear that. I know my colleague on the other side of the aisle, Mr. Duffy, would be as well.

Moving on to cross-border swaps, another kind of esoteric area, but an area on which I have worked with the Chair of this committee to try to get harmonization, we have taken a lot of heat from our approach. You came out with a rule just yesterday, I think.

Could you talk about that? And in particular, your piece of the market is small, security-based swaps, I guess. What kind of coordination went into it with the CFTC?

Mr. LUPARELLO. Careful coordination with both the CFTC and the other regulators. The vast majority of what we did yesterday is very consistent with the CFTC approach.

There are clearly a couple of areas where we come up with a slightly different answer. Some of that is driven by our understanding of the workability of our markets. Some of it is driven by slight differences in the statute and potentially different authority questions.

But literally all we did yesterday was clarify, given that the swaps market is fundamentally a cross-border market, some very substantial percentage of trades are between a U.S. person and a non-U.S. person—clarifying what transactions gave—would give rise to registration—

Mr. CARNEY. Would you agree that the objective is to get harmonization of regulations across market venues around the world?

Mr. LUPARELLO. Absolutely. And so, part of this is it is not just coordinating with the domestic regulators, but coordinating with the international regulators.

Mr. CARNEY. What do you think is the biggest challenge there? What do we need to be concerned about?

There was some reporting about—and I know the ranking member has expressed some concern about non-guaranteed entities or something.

Could you comment on that briefly?

Mr. LUPARELLO. Yes. One of the big issues that we dealt with yesterday was the question of when you have a non-U.S. person that—you know, a subsidiary of a U.S. bank that is located in London, for example, and they do a transaction with another non-U.S. person. If that transaction is guaranteed by the U.S. bank. If there is an explicit recourse guarantee.

It is really—the economic reality of that transaction is that the German hedge fund is actually doing business with the New York bank. So requiring that transaction to be counted for jurisdictional purposes made sense to us.

When those guarantees become softer, there are some questions about whether we can reach what is essentially a transaction between one non-U.S. entity and another non-U.S. entity.

And so part of this is—those are very difficult nuanced questions that do have the color of what our authority is over transactions that involve two non-U.S. persons, one of the difficult issues we try to navigate.

Mr. CARNEY. My time is up. I would encourage you to keep working on that. It is, we believe, a very important issue. I work with the Chair on it and also encourage your cooperation and work with Department of Labor on fiduciary as well.

Mr. LUPARELLO. I appreciate it.

Mr. CARNEY. Thank you.

Chairman GARRETT. I thank the gentleman.

And I thank the Director.

Before I let you go, Vice Chairman Hurt and I wrote a letter to Chair White several weeks back with regard to venture exchanges and the work that is being done there.

Do you know when we will be receiving a response? Or do you want to just comment on that topic in general?

Mr. LUPARELLO. I will find out when the response is coming.

And, as I said, I think we are open to a variety of potential solutions and look to flexibility at different segments of the market.

Conversations I have had with market participants and experts before I started at the Commission around venture exchanges create many sort of, I think, interesting opportunities.

Chairman GARRETT. Opportunities. Yes.

Mr. LUPARELLO. As is always the case, there are occasionally authority questions that go along with that, which need to be navigated. But we continue to think that this is an idea worthy of further conversation.

Chairman GARRETT. Great. I appreciate your answer.

That brings the hearing to a close.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place his responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, the hearing is adjourned. And thank you again.

Mr. LUPARELLO. Thank you, Mr. Chairman.

[Whereupon, at 10:52 a.m., the hearing was adjourned.]

# A P P E N D I X

June 26, 2014

**Testimony on "Oversight of the SEC's Division of Trading and Markets"**
**by**
**Stephen Luparello, Director**
***Division of Trading and Markets***
***U.S. Securities and Exchange Commission***

**Before the United States House of Representatives Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services**

**June 26, 2014**

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee:

Thank you for inviting me to testify on behalf of the U.S. Securities and Exchange Commission (Commission) regarding the Division of Trading and Markets' (Division) activities and responsibilities.

The mission of the Division is to support the Commission's mandate by fostering investor protection and establishing and maintaining standards for fair, orderly, and efficient markets. To this end, the Division is responsible for the rules that apply to many of the major participants in the U.S. securities markets, such as exchanges, clearing agencies, alternative trading systems (ATS), broker-dealers, transfer agents, securities information processors (SIP), the Financial Industry Regulatory Authority (FINRA), and the Securities Investor Protection Corporation. The Division also oversees the rulemaking activities of the exchanges, clearing agencies, and FINRA in their capacity as self-regulatory organizations (SROs), monitors risks at large broker-dealers and clearing agencies, and assists the Commission with major international regulatory coordination efforts.

The Division works closely with other divisions and offices within the Commission, including the Office of Credit Ratings with respect to the regulation of nationally recognized statistical rating organizations and the Office of Municipal Securities with respect to the oversight of the Municipal Securities Rulemaking Board (MSRB) and certain municipal securities market participants.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the Jumpstart Our Business Startups Act (JOBS Act) added substantial new responsibilities to the Division's portfolio. The Division is primarily responsible for more than 30 separate mandatory rulemaking initiatives and studies under the two statutes, as well as the ongoing oversight and implementation they require. These new responsibilities include:

- The creation of a new regulatory structure for over-the-counter (OTC) derivatives, including clearing, trading, reporting, and registration rules;

- The regulation and monitoring of clearing agencies designated as systemically important;

- The prohibition of proprietary trading by insured depository institutions and their affiliates, part of the "Volcker Rule"; and

- The development of new rules for intermediaries engaged in "crowdfunding," a novel mechanism for obtaining capital from a large number of investors.

Although the Division's day-to-day and long-term focus covers a much wider set of initiatives and mandates, I want to highlight in this testimony five key areas of responsibility and our current efforts in each: first, equity market structure and related initiatives involving market infrastructure; second, our work to implement rules for OTC derivatives as required under Title VII of the Dodd-Frank Act (Title VII); third, rulemaking to enhance standards for certain registered clearing agencies; fourth, our consideration of rulemaking under Section 913 of the Dodd-Frank Act relating to the standards of care and other obligations for broker-dealers and investment advisers; and, fifth, initiatives in the fixed income markets.

**Equity Market Structure Review**

The U.S. equity markets are the strongest in the world, reliably serving millions of investors and facilitating capital formation for thousands of public companies. To ensure they continue to provide this critical function, a series of initiatives to evaluate and enhance equity market structure are at the forefront of the Division's priorities. The Division will play a lead role in the comprehensive review of equity market structure described by Chair White in a recent speech.[1] This initiative will include a review of the evolution of market practices over the last decade and the role of Commission rules - in particular Regulation NMS - in that evolution, and the need for any adjustments or enhancements to that structure.

Chair White recently directed the Division to begin taking a number of specific actions relating to, among other things, high-frequency trading, market transparency, and broker conflicts of interest. The Division is preparing recommendations for the Commission to consider regarding:

- Clarifications of the regulatory status of unregistered active proprietary traders acting as "dealers";

- Elimination of an exception from FINRA membership requirements for dealers that trade in off-exchange venues;

- Improvements in firms' management of algorithm risks and enhancements to regulatory oversight of their use;

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[1] *See* Mary Jo White, Chair, U.S. Securities and Exchange Commission, Enhancing Our Equity Market Structure, Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference (June 5, 2014), http://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370542004312.

- An anti-disruptive trading rule that would apply to active proprietary traders in narrow time periods when liquidity is most vulnerable and the risk of price disruption caused by aggressive short-term trading strategies is highest;

- Expansion of the information about ATS operations that is required on Form ATS and making that information publicly available;

- Enhanced order routing disclosures for institutional investors; and

- The creation of a new Market Structure Advisory Committee of experts to review specific initiatives and rule proposals.

The Division is also working with FINRA and the exchanges to advance several initiatives, including efforts to:

- Minimize consolidated data latency and enable users of the consolidated feeds to better monitor the latency of their data;

- Clarify how exchanges use direct or consolidated data feeds for particular purposes;

- Expand FINRA's recently launched ATS trading volume disclosure regime to include non-ATS off-exchange activity; and

- Review order types offered by the exchanges and clarify their operation as appropriate.

Another important part of the review is developing recommendations to improve the markets for smaller issuers. As noted by the Chair, one of the core principles guiding our review of equity market structure is the recognition that one size does not fit all; we need to account for the varying nature of companies and products, with a particular sensitivity to the needs of smaller companies and their investors.[2] The Commission is continuing its evaluation of decimalization rules that allow, but do not require, market participants to quote security prices in increments as low as a penny and, in particular, the impact of decimalization on smaller companies. Most recently, on June 24, 2014, the Commission approved an order requiring the exchanges[3] and FINRA to submit a plan to the Commission within 60 days to implement a tick size pilot that would widen the quoting increment and the trading increment for certain smaller company securities.

As described in the order, the pilot would last for one year and would include securities with: (1) a market capitalization of $5 billion or less; (2) an average daily trading volume of one

[2] *Id.*

[3] BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., The Nasdaq Stock Market LLC, Nasdaq OMX BX, Nasdaq OMX Phlx, National Stock Exchange, Inc., New York Stock Exchange LLC, NYSE Arca, Inc., and NYSE MKT LLC.

million shares or less; and (3) a share price of $2 per share or more. The pilot would consist of one control group and three test groups with 300 securities each. The control group is to be quoted at the current tick size increment of one penny per share and trading would continue at any price increment that is permitted today. The three test groups would include: (a) securities quoted in five cents minimum increments with trading at any price increment that is permitted today; (b) securities quoted in five cents minimum increments with trading also in five cents increments, subject to certain limited exceptions; and (c) securities quoted in five cents minimum increments with trading in five cents increments subject to rules that would generally prevent price matching by a trading center that is not displaying the national best bid or offer.

The pilot is expected to yield significant data and facilitate a meaningful review of the effect of tick size on liquidity, execution quality for investors, market maker participation, volatility, competition, transparency and institutional ownership.

Besides the pilot, the Division will also be exploring other ways to potentially improve the markets for smaller issues, and encouraging the development of market-based solutions.

**Equity Market Infrastructure and Extraordinary Volatility**

In addition to emphasizing the importance of conducting a comprehensive review of equity market structure, recent market events have demonstrated the need to bolster resilience throughout critical market systems. Following the August 2013 interruption in the trading of Nasdaq-listed securities, Chair White convened a meeting with the leaders of the equities and options exchanges, FINRA, and the clearing agencies. Shortly following that meeting, each of the exchanges, FINRA, and the clearing agencies prepared action plans for addressing the kinds of issues arising from that incident and are working to implement these plans, including through several measures that should be completed in the near future. For example, the exchanges have developed enhanced SIP backup capabilities and they expect to implement a new "hot-warm" backup regime for the two equity SIPs with a ten-minute recovery standard by the end of this month. The equity exchanges also have largely completed rule and market participant functionality development of "kill switch" mechanisms that are designed to allow exchanges to shut down trading in the event of a technological failure.

Additionally, in an effort to improve the Commission's oversight of market infrastructure, in March 2013, the Commission proposed Regulation Systems Compliance and Integrity (Regulation SCI) to supersede and replace the Commission's Automation Review Policy inspection program and aspects of Regulation ATS. As proposed, Regulation SCI would apply to the systems of exchanges, clearing agencies, SIPs, and certain ATSs. The proposed rule would require these entities to have in place policies and procedures reasonably designed to help ensure that their systems are robust, secure, and compliant; and require their key members to participate in business continuity and disaster recovery testing.

In addition, as proposed, Regulation SCI would require these entities to notify the Commission of certain events with respect to key systems, including disruptions, intrusions, and systems compliance issues; and notify their members or participants of certain systems problems. The proposed rules would also enhance Commission oversight of securities market infrastructure more generally by requiring covered entities to keep the Commission informed about material systems changes and to conduct an annual review of their automated systems.

The Commission received a significant number of comments on the proposal, and the staff is carefully considering those comments in preparing a recommendation for the Commission.

These market resiliency initiatives complement the Market Access Rule adopted by the Commission in November 2010, which was designed to reduce the risks faced by brokers, as well as the markets, which in turn would reduce risk to the financial system as a whole, by requiring brokers with market access to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage financial and regulatory risks, including a requirement to apply certain controls on a pre-trade basis.[4] This market access risk includes, for example, the potential for erroneously submitting a single large order or a flood of small orders that disrupt trading.

Beyond these efforts, the Division has completed a number of measures designed to mitigate extraordinary market volatility in the wake of the May 2010 "Flash Crash." Most recently, the Commission approved an SRO plan to implement a "limit up-limit down" mechanism to create "speed bumps" to limit abrupt market movements in individual securities,[5] and amendments to the market-wide circuit breakers to provide for brief, coordinated trading halts across the securities and futures markets during a sharp decline.[6]

**Equity Market Data Analysis**

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4 *See* Risk Management Controls for Brokers or Dealers with Market Access, Exchange Act Release No. 63,241, 75 Fed. Reg. 69,792 (Nov. 15, 2010).

5 *See* Order Approving, on a Pilot Basis, the National Market System Plan To Address Extraordinary Market Volatility, Exchange Act Release No. 67,091, 77 Fed. Reg. 33,498 (June 6, 2012); Notice of Filing and Immediate Effectiveness of the Second Amendment to the National Market System Plan To Address Extraordinary Market Volatility, Exchange Act Release No. 68,953, 78 Fed. Reg. 13,113 (Feb. 26, 2013); Order Approving the Third Amendment to the National Market System Plan To Address Extraordinary Market Volatility, Exchange Act Release No. 69,287, 78 Fed. Reg. 21,483 (Apr. 10, 2013).

6 *See* Notice of Filing of Amendments No. 1 and Order Granting Accelerated Approval of Proposed Rule Changes as Modified by Amendments No. 1, Relating to Trading Halts Due to Extraordinary Market Volatility, Exchange Act Release No. 67,090, 77 Fed. Reg. 33,531 (June 6, 2012). The operative date of the revised circuit breakers was delayed from February 4, 2013 to April 8, 2013. *See, e.g.*, Notice of Filing and Immediate Effectiveness of Proposed Rule Change Delaying the Operative Date of A Rule Change to NYSE Rule 80B, Exchange Act Release No. 68,784, 78 Fed. Reg. 8662 (Feb. 6, 2013). The NMS Plan related to limit up-limit down was implemented in two phases. Phase I applied to stocks in the S&P 500 Index, the Russell 1000 Index, and select exchange-traded products and began on April 8, 2013. Phase II applied to all remaining NMS securities and began on August 5, 2013. The SROs rolled out Phase II in two parts. The first part extended the limit up-limit down mechanism to the first fifteen minutes of the trading day and to all remaining NMS securities. This was completed on December 8, 2013. The second part extended the limit up-limit down mechanisms to the last fifteen minutes of the trading day. The extension to the last fifteen minutes of the trading day occurred on February 24, 2014.

The SEC also recently launched a market structure data website,[7] which reflects its data-driven approach to a wide range of important and pressing market structure issues, including those identified above. The website is intended to promote a market-wide dialogue and fuller empirical understanding of the equity markets. It serves as a central location for Division staff to publicly share evolving data, research, and analysis. The website includes:

- Detailed analyses of trading data by the Division's Office of Analytics and Research (OAR). OAR has implemented a Market Information Data Analytics System (MIDAS) to collect and analyze market data from both the public consolidated data feeds and the "proprietary" data feeds provided by the exchanges to their customers. OAR has analyzed MIDAS data to address key issues raised by the current market structure, including trading speed, quote lifetimes, trade-to-order volume ratios, hidden volume ratios, and odd-lot rates;

- Research papers prepared by the Division of Economic and Risk Analysis (DERA). The papers use order audit trail data to provide basic descriptive statistics about off-exchange trading venues, which currently account for more than one third of volume in exchange-listed equities; and

- Staff summaries of economic research on equity market structure authored by academics, regulators, and others that analyze data relating to a variety of financial markets and products, both in the United States and globally.

The Division also has facilitated a number of important Commission initiatives to significantly improve the Commission's own access to market data, including information generated pursuant to rules approved by the Commission in July 2011 to capture additional information on certain large traders.[8] The Division also is focused on administering Commission rules approved in July 2012 that require the SROs to draft and submit a plan for the Commission's approval to create, implement, and maintain a consolidated audit trail (CAT) that would be designed to allow regulators to track all activity throughout the U.S. markets in exchange-traded equity securities and listed options.[9] The deadline for the SROs to submit the CAT plan to the Commission is September 30, 2014, and, recognizing that the CAT is a critical regulatory initiative, Division staff is closely monitoring the SROs' progress. To date, Division staff has been informed that the SROs engaged in a request for proposal process and received 10

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7 *See* Market Structure, U.S. Securities and Exchange Commission, http://www.sec.gov/marketstructure/ (last visited June 20, 2014).

8 *See* Large Trader Reporting, Exchange Act Release No. 64,976, 76 Fed. Reg. 46,960 (Aug. 3, 2011).

9 *See* Consolidated Audit Trail, Exchange Act Release No. 67,457, 77 Fed. Reg. 45,722 (Aug. 1, 2011).

bids from entities interested in operating the CAT.[10] The SROs are now in the process of evaluating the bids.[11]

**OTC Derivatives**

While pursuing these important initiatives in the equity markets space, the Division also is working to fulfill the Dodd-Frank Act Title VII mandate to establish a new regulatory regime for "security-based swaps" that historically traded over the counter. These rules are intended to achieve a number of goals, including:

- Facilitating the centralized clearing of swaps, with the intent of reducing counterparty and systemic risk;
- Increasing market transparency for regulators and market participants;
- Addressing capital and margin requirements for security-based swap dealers and major security-based swap participants; and
- Addressing potential conflict of interest issues relating to security-based swaps.

To date, the Commission has proposed all of the rules required by Title VII of the Dodd-Frank Act, adopted a number of final rules and interpretations, provided a "roadmap" for the further implementation of its Title VII rulemaking, and taken other actions to provide legal certainty to market participants during the implementation process. The Commission's most recent efforts include proposing rules relating to books and records and reporting requirements for security-based swap dealers and major security-based swap participants[12] and proposing rules to enhance the oversight of clearing agencies that are deemed to be systemically important or that are involved in complex transactions, such as security-based swaps.[13] Division staff continues to work to develop recommendations for final rules required by Title VII. In addition, Division staff has been actively engaged in ongoing discussions with domestic and foreign regulators regarding the direction and coordination of international derivatives regulation.

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[10] *See* SEC Rule 613 Consolidated Audit Trail RFP Bid Submissions (last updated Apr. 2, 2014), http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p469129.pdf.

[11] *See* Order Approving Proposed National Market System Plan Governing the Process of Selecting a Plan Processor and Developing a Plan for the Consolidated Audit Trail, Exchange Act Release No. 71,596, 79 Fed. Reg. 11,152 (Feb. 27, 2014).

[12] *See* Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71,958, 79 Fed. Reg. 25,194 (May 2, 2014).

[13] *See* Standards for Covered Clearing Agencies, Exchange Act Release No. 71,699, 79 Fed. Reg. 16,866 (Mar. 26, 2014).

**Financial Market Utilities**

The Division is also continuing its efforts to establish rules pursuant to mandates set forth in Title VIII of the Dodd-Frank Act to provide for increased regulation of financial market utilities[14] (FMUs) and financial institutions engaging in payment, clearing, and settlement activities that are designated as systemically important.

*Proposal of Covered Clearing Agency Standards*

An important step in that process came with the Commission's March 12, 2014 proposal to enhance the oversight of clearing agencies.

Under the proposed rules, certain systemically important clearing agencies and clearing agencies otherwise engaged in activities with complex risk profiles (such as central counterparty services with respect to security-based swaps) would be required to establish, implement, maintain and enforce policies and procedures reasonably designed to address key aspects of their risk management and operation, including:

- Financial risk management;
- Settlement;
- Default management;
- Business and operational risk management; and
- Access to the covered clearing agencies.

While many of these requirements would reflect enhancements of the Commission's existing oversight program for registered clearing agencies, several requirements would be newly specified in light of the nature and extent of the activities of the clearing agencies to be covered by the standards. The significant new requirements would address:

- Governance and comprehensive risk management;
- Financial risk management; and
- General business risk.

[14] Section 803(6)(A) of the Dodd-Frank Act defines a "financial market utility" as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person." 12 U.S.C. § 5462(6)(A).

The comment period on the proposal closed on May 27, 2014, and Division staff is working towards a recommendation to the Commission regarding the final rules for covered clearing agencies.

*Enhanced Supervision of Systemically Important Financial Market Utilities*

Another significant regulatory change brought by Title VIII of the Dodd-Frank Act was the authorization of FSOC to designate an FMU as systemically important if the failure, or a disruption to the functioning, of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets, thereby threatening the stability of the U.S. financial system. In July 2012, FSOC designated eight FMUs as systemically important under Title VIII (DFMUs).[15]

Title VIII provides a framework for an enhanced supervisory regime for DFMUs. It permits the Commission to prescribe regulations for risk management and operations, and also directs the Commission to take into consideration relevant international standards and existing prudential requirements for the DFMUs it supervises.[16] The Commission is also required to examine DFMUs annually.

Title VIII also establishes a process for a DFMU to submit to the Commission, with a copy to the Federal Reserve, advance notices identifying changes to its rules, procedures, or operations that could materially affect the nature or level of risk presented by the FMU.[17] In June 2012, the Commission adopted rules that establish procedures for how it will address these advance notices,[18] and it has since considered a significant number of such notices.[19]

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15 The Commission acts as the supervisory agency for four of the eight FMUs: the Depository Trust Company, Fixed Income Clearing Corporation, National Securities Clearing Corporation, and The Options Clearing Corporation. Two other clearing agencies registered with the Commission for which the Commodity Futures Trading Commission (CFTC) is the primary supervisory agency are designated systemically important: Chicago Mercantile Exchange, Inc. and ICE Clear Credit LLC. The Federal Reserve Board acts as primary supervisory agency for two payment systems that were designated as systemically important FMUs: CLS Bank International and the Clearing House International Payments System.

16 *See* Dodd-Frank Act § 805(a)(2), 12 U.S.C. § 5464(a)(2). Division staff also worked jointly with the staffs of the CFTC and the Federal Reserve to submit a required report to Congress in July 2011 discussing recommendations regarding risk management supervision of clearing entities that are DFMUs. *See* Risk Management Supervision of Designated Clearing Entities, Report by the Board of Governors of the Federal Reserve System, Commission and CFTC (July 2011), http://www.sec.gov/news/studies/2011/813study.pdf. The report discussed several recommendations, including finalizing rulemakings to establish enhanced risk management for such clearing entities, formalizing the process for ongoing consultations and information sharing regarding such clearing entities and systemic risk, and enhancing clearing entity examinations.

17 *See* Dodd-Frank Act § 806(e)(4), 12 U.S.C. § 5465(e)(4).

18 *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, Exchange Act Release No. 67,286, 77 Fed. Reg. 41,602 (July 13, 2012).

19 Advance notices are published on the Commission's website at http://www.sec.gov/rules/sro.shtml.

**Investment Advisers and Broker-Dealers' Standards of Conduct**

With respect to standards of conduct for investment advisers and broker-dealers, I want to note that the staff is considering whether, and if so, how, to recommend the Commission use its authority under Section 913 of the Dodd-Frank Act to adopt rules establishing a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers.

Last year, to inform its consideration, the Commission issued a public Request for Data and Other Information relating to the provision of retail investment advice and regulatory alternatives.[20] The Commission sought, among other things, information relating to the potential impacts a uniform fiduciary standard of conduct, or other regulatory approaches, may have on retail investor costs and access to personalized investment advice and product and service offerings, and how any negative impacts could be mitigated.

In order to more fully inform the Commission's decision on this issue, Chair White has directed the Division to work with colleagues in DERA and the Division of Investment Management to evaluate potential options, in light of the information available, for the Commission's consideration.

Separately, Division staff, along with staff from the Division of Investment Management, are providing technical assistance to Department of Labor (DOL) staff as the DOL considers potential changes to the definition of "fiduciary" under the Employee Retirement Income Security Act. Among other things, the staff is seeking to assess the practical impact potential DOL rulemaking may have on investors who seek to access advice from financial services providers, including broker-dealers.

**The Fixed Income Markets**

The Commission also oversees the fixed income markets, which are sizeable and relatively illiquid, opaque, and decentralized, with trading occurring primarily with dealers rather than through more transparent venues like exchanges or alternative trading systems. And while transaction prices for fixed income securities are now available to investors shortly after the trade occurs, the amount of pre-trade pricing information – bids and offers – is limited, and is not widely available to the investing public.

In order to improve the quality and transparency of the prices received by fixed income investors, staff of the Division and the Commission's Office of Municipal Securities anticipate working closely with FINRA and the MSRB on initiatives concerning best execution in municipal securities transactions and broker-dealers disclosing to customers their markups in riskless principal transactions for corporate and municipal bonds. In addition, the Chair has instructed Division staff to develop for the Commission's consideration a recommendation that

[20] *See* Duties of Brokers, Dealers and Investment Advisers, Exchange Act Release No. 69,013, Investment Advisers Act Release No. 3558, 78 Fed. Reg. 14,848 (Mar. 7, 2013).

would require the public dissemination of the best prices generated by ATSs and other electronic dealer networks in the corporate and municipal bond markets.

**Conclusion**

Thank you again for inviting me to discuss the Division's activities and responsibilities. I look forward to answering your questions.

**The Honorable Luke Messer**
**Capital Markets and Government Sponsored Enterprises Hearing on "Oversight of the SEC's Division of Trading and Markets"**
**June 26, 2014**

**Market Structure**

**As you know, in 2012, the SEC adopted a rule requiring the formation of a Consolidated Audit Trail (CAT).**

**What is the status of the CAT?**

**Response:** As you know, the SEC's rule requires FINRA and the eighteen registered securities exchanges (collectively, the "SROs") to develop a national market system ("NMS") plan to create, implement and maintain the consolidated audit trail. To help the SROs develop the CAT NMS plan, in February 2013 the SROs issued a request for proposal to solicit bidders to operate the CAT and received 10 bids in response to their request for proposal in March 2014. The SROs narrowed the bids to a shortlist of six bidders in July 2014. The SROs filed the CAT NMS plan with the SEC based on these six bids on September 30, 2014.

The SEC staff is now reviewing the submitted plan in order to make a recommendation to the Commission regarding publication of the plan for notice and public comment, a process that all NMS plans must undergo. Following this comment period, if the SEC approves the CAT NMS plan, full implementation of the plan would commence.

**Could you describe how the CAT will interact with and/or replace the SEC's MIDAS program and FINRA's market data?**

**Response:** The CAT is a regulatory system that will contain significant amounts of non-public data, and thus will provide the SEC with a much broader view of the markets than can be obtained with MIDAS alone. The MIDAS system is designed to collect and process data available from a variety of existing public commercial feeds. These non-regulatory feeds provide the SEC with the ability to analyze market data based on what other market participants see. Being able to analyze data as seen directly by the public is different from what can be done with the CAT, as CAT data will be collected and processed via non-public channels that are substantively different than the feeds used by the public.

As with all systems, SEC staff review current usage and needs on an on-going basis. Following approval and implementation of CAT, a review of MIDAS (as well as other SEC systems) would consider any overlap with the CAT functionality and data.

With respect to how the CAT will interact with and/or replace FINRA's market data, including data collected by FINRA's Order Audit Trail System ("OATS"), I note that SEC rules require the SROs developing the CAT to, among other things, formulate a plan to eliminate existing rules and systems (or components thereof) that will be rendered duplicative by the consolidated audit trail. I understand that the SROs have already conducted a "gap analysis" study to determine the differences between the CAT and OATS, with a goal of sunsetting OATS.

**How will the CAT help the SEC develop a better understanding of equity market structure over time?**

**Response:** The SEC relies on market data to enhance its understanding of how markets operate and evolve, including with respect to the development of new trading practices, the reconstruction of atypical or novel market events, and the implications of new markets or market rules. The effectiveness of such efforts often is dependent on the quality of the data available, which currently comes from multiple sources for cross-market activities, such as separate SRO audit trails.

Each of the sources of market data currently available to the SEC presents certain limitations. For instance, existing SRO audit trails lack key information that would be useful for regulatory oversight, such as the identity of the customers who originate orders, or the fact that two sets of orders may have originated with the same customer. Though SEC staff also has access to sources of market activity data other than SRO audit trails, these systems each have their own limitations. For example, data obtained from the electronic blue sheet system and the National Securities Clearing Corporation equity cleared reports (reports showing the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member) comprise only trade executions, and not orders or quotes. In addition, like data from existing audit trails, data from these sources lack key elements important to the SEC, such as information on routes, modifications, and cancellations, and, in the case of equity cleared reports, the identity of the customer.

Overall, the national market system is complex, dispersed, and highly-automated, and, in performing its oversight responsibilities, SEC staff today must attempt to piece together disparate data from a variety of information systems lacking in completeness, accessibility, and/or timeliness – a model that neither supports the efficient aggregation of data from multiple trading venues nor yields the type of complete and accurate market activity data to optimize robust market oversight.

The CAT rule requires the submission of an NMS plan to create, implement, and maintain the first comprehensive audit trail for the U.S. securities markets, which will allow for the prompt and accurate recording of material information about all orders in NMS securities, including the identity of customers, as these orders are generated and then routed throughout the U.S. markets until execution, cancellation, or modification. This information will be consolidated and made readily available to regulators in a uniform electronic format as the CAT. Ultimately, the CAT is expected to improve the quality of audit trail data by, among other things: (1) identifying the account holder(s) with respect to an account at a registered broker-dealer and, if different, the person(s) authorized to give the broker-dealer trading instructions for such account; (2) identifying the time of each key event in the life of an order according to synchronized business clocks; (3) requiring the reporting of comprehensive order lifecycle data; and (4) including all NMS securities in one audit trail. These data improvements should improve the SEC's ability to analyze and reconstruct broad-based market events, monitor overall market structure and perform market analyses.

**Volcker Rule**

**Since your arrival at the Commission in March, have you spoken with FINRA about how you expect FINRA to examine for Volcker Rule compliance?**

**Response:** Under section 19(g) of the Securities Exchange Act of 1934 ("Exchange Act"), self-regulatory organizations are responsible for enforcing compliance with rules adopted under the Exchange Act. Thus, at this time, FINRA does not have the statutory responsibility to examine for or enforce compliance with the final rule.

SEC staff has received a few preliminary questions from FINRA staff regarding FINRA's role in examining for and enforcing compliance with the final rule for banking entities that are SEC-registered broker-dealers. Because the final rule was adopted under the Bank Holding Company Act, FINRA does not have a statutory responsibility to enforce compliance with the Volcker rule.

**Will the SEC authorize FINRA to examine for Volcker compliance?**

**Response:** As noted above, under section 19(g) of the Exchange Act, self-regulatory organizations are responsible for enforcing compliance with rules adopted under the Exchange Act. Thus, at this time, FINRA does not have the statutory responsibility to examine for or enforce compliance with the final rule.

SEC staff is considering how best to integrate FINRA's routine examinations of its broker-dealer members with respect to compliance with the recordkeeping, reporting and compliance program requirements of the Volcker rule.

**Will FINRA use SEC-approved materials to train their staff or will FINRA have to submit its Volcker-exam program for SEC review and approval?**

**Response:** The interagency working group is coordinating on issues related to examinations and supervision. SEC staff is continuing to think about examiner training and examination plans in close coordination with the other agencies. Though FINRA is not involved in interagency group discussions, SEC staff continues to maintain open lines of communication with FINRA. As discussed above, FINRA does not currently have the statutory responsibility to examine for or enforce compliance with the Volcker rule.

**Questions for the Record**

**Submitted by Representative Stephen Fincher (Tennessee's 8th District)**

**"Oversight of the SEC's Division of Trading and Markets"**

**Thursday, June 26, 2014**

**Subcommittee on Capital Markets and Government Sponsored Enterprises**

**Questions to Mr. Stephen Luparello, Director, Division of Trading and Markets, Securities and Exchange Commission**

**Market Structure**

1. **Will you commit to putting SEC, academic, and industry studies and reviews out for peer review before drawing any conclusions about the data?**

   **Response:** In 2013, the SEC launched its market data website as a means of enhancing the agency's ability to promote better understanding of our equity markets and equity market structure through the use of data and analytics. An integral part of the website is the posting of data highlights and white papers prepared by SEC staff. Data highlights are periodically prepared by SEC staff based on data snapshots generated by the SEC's Market Information Data and Analytics System when new data series are created by that system or noteworthy changes or developments occur. White papers rely on a variety of data sources to provide insights into the structure of the equities markets.

   In preparing any data highlights or white papers for posting on the website, SEC staff engages in a rigorous internal review process that includes substantive participation by staff economists and market structure experts.

2. **What types of data does the SEC need to develop to conduct a comprehensive review of Reg. NMS and equity market structure?**

   **Response:** The SEC can use a wide variety of data to assess the performance of Regulation NMS and equity market structure. Specifically, this data includes metrics that measure: (i) spreads – the difference between the prices that buyers pay and sellers receive when they are seeking to trade immediately at the best prices (e.g., quoted spreads, effective spreads, and realized spreads); (ii) price impact; (iii) net price improvement; (iv) execution speed; (v) fill rates; (vi) variance ratios; (vii) quoted size at the inside prices; (viii) the effect of reserve size and undisplayed size at the inside prices or better; and (ix) quoted depth at prices away from the inside. SEC staff has the ability to analyze these metrics using data collected under Regulation NMS. Another useful metric is large order transaction costs, which typically require access to institutional order data that is not publicly available. However, a few trading analytics firms with access to institutional order data publish periodic analyses of institutional investor transaction costs. These analyses allow such costs to be tracked over time to determine whether they are increasing or decreasing.

Overall, the SEC has access to these types of data to conduct a comprehensive review of Regulation NMS and equity market structure. The Consolidated Audit Trail ("CAT"), however, will be the first comprehensive audit trail for the U.S. securities markets and should improve the SEC's ability to analyze market events and to monitor overall market structure by allowing the collection and analysis of additional important data points.

**What does the SEC already have?**

**Response:** As noted above, the SEC has access to a variety of market data necessary to conduct a comprehensive review of Regulation NMS and equity market structure. In addition, SEC staff currently use the electronic blue sheet ("EBS") system (trading records requested by the SEC from broker-dealers that are used in regulatory investigations to identify buyers and sellers of specific securities), and the National Securities Clearing Corporation equity-cleared reports (reports showing the number of trades and daily volume of all equity securities in which transactions took place, sorted by clearing member).

Recently, the SEC has created two additional sources of data – large trader reporting ("Large Trader") and the MIDAS system ("MIDAS"). Large trader reporting requires certain market participants to identify themselves to the SEC as "large traders." Broker-dealers are required to report to the SEC with respect to large trader transactions, and to capture and report through the EBS system the time of execution for any trade involving a large trader as well as an SEC-issued large trader identifier that identifies the large trader. MIDAS is designed to collect and process data available from a variety of existing commercial feeds that provide the SEC an ability to analyze market data based on what market participants see, including when they see such data. SEC staff also has access to audit trail systems for certain segments of this trading activity that the Financial Industry Regulatory Authority and the exchanges currently maintain, which vary in scope, required data elements, and format.

**What additional data does it need?**

**Response:** The completeness and efficacy of the staff's analysis of market structure issues is limited by the sources of market data currently available to the SEC. One of the most significant limitations of current data sources is the lack of customer identification. The EBS system is today the only available source of data that allows regulators to obtain the identity of customers of broker-dealers who have executed trades. However, EBS data are limited to executed trades and do not contain information on orders or quotes (and, thus, no information on routes, modifications, and cancellations). Furthermore, with the exception of information reported under the SEC's large trader regime, the EBS data currently includes only the dates, but not the times, of each trade execution. Other existing audit trails lack customer identifiers. This limitation makes the process of identifying the customers involved in unusual trading patterns or market events very difficult. Even determining whether or not an unusual trading pattern exists is challenging if the data does not identify trades by a single customer at multiple broker-dealers.

Additionally, due to the number of audit trails with disparate requirements and different formats, there is no comprehensive audit trail that provides the SEC with accurate, complete, accessible, and timely data on all the markets it oversees. Consequently, the data currently available to the SEC falls short of providing an efficient source of data for analyzing cross-market activities, or tracking an order through its entire lifecycle from generation through routing to execution, modification, or cancellation. Further, some of the existing audit trail data also suffers from a lack of timeliness, and none of it is stored in a market-wide database or a central repository that is readily accessible to the SEC.

**Does the SEC necessarily need the Consolidated Audit Trail to be completed in order to continue gathering all of this data?**

**Response:** As noted above, the SEC has access to a variety of market data necessary to conduct a comprehensive review of Regulation NMS and equity market structure. The CAT, however, will be the first comprehensive audit trail for the U.S. securities markets and will significantly improve the SEC's ability to monitor overall market structure. In particular, the CAT will allow for the prompt and accurate recording of material information about all orders in NMS securities, including the identity of customers, as these orders are generated and then routed throughout the U.S. markets until execution, cancellation, or modification. The information reported to the CAT will be consolidated and made readily available to the SEC in a uniform electronic format.

Ultimately, the CAT will improve the quality of data available to the SEC and other regulators by, among other things: (1) identifying the account holder(s) with respect to an account at a registered broker-dealer and, if different, any person(s) authorized to give the broker-dealer trading instructions for such account; (2) identifying the time of each key event in the life of an order according to synchronized business clocks; (3) requiring the reporting of comprehensive order lifecycle data; (4) integrating trade and quote data for all NMS securities into a central repository; and (5) including all NMS securities in one audit trail. These data improvements should result in the improved analysis and reconstruction of broad-based market events, and the improved ability of the SEC to monitor overall market structure and perform market analyses.

3. **In the SEC's adopting release for the Consolidated Audit Trail issued two years ago, the SEC stated that a number of open questions remain about market structure issues because of a lack of consolidated market data. The release noted that existing research cannot precisely define high frequency traders and that, as a result of data gaps, studies of high frequency trading have been limited in their ability to evaluate the impacts of high frequency trading on U.S. equity markets.**

   **Do we currently have a universally accepted definition of high frequency trading?**

**Doesn't this suggest that we need to study in more detail how and why these firms came in existence and what they do before we jump to conclusions and impose additional layers of regulation on the equity markets?**

__Response:__ I believe that the responsible approach to regulating high-frequency trading ("HFT") is to understand the different types of HFT, assess strategies, and formulate appropriate action to address concerns. As such, the staff is concentrated on the conduct of high-frequency traders. For example, the Commission's Concept Release on Equity Market Structure focused on the strategies and tools used by HFTs, noting that there are a variety of strategies, including passive market making, arbitrage, structural, and directional strategies, and soliciting comments on such strategies. Specifically, the concept release raised concerns with certain directional strategies, such as "order anticipation" strategies that try to detect large trading interest solely in order to trade ahead of it, and "momentum ignition" strategies that attempt to trigger a price movement by "spoofing" other algorithms. Additionally, the Commission discussed special tools used by HFTs including co-location services – where the HFT places its trading engine next to the exchange's server to minimize latencies – and high-speed market data feeds distributed directly by the exchanges.

Separately, the staff has undertaken a data-driven approach to investigating HFT that is intended to provide a strong empirical basis to sort through the various views about HFT and market quality. Among other things, SEC staff closely reviews economic research on HFT – primarily based on objective data, rather than anecdotes. This past March, a review by Commission staff of HFT economic literature was posted on the SEC's market structure website to further inform the public debate.

__Derivatives__

1. **Is the SEC's adoption of a rule to govern the extraterritorial application of Title VII of Dodd-Frank preferable to interpretive guidance issued by the CFTC?**

__Response:__ As your question indicates, the SEC and the CFTC have taken different procedural approaches to addressing the issue of the application of Title VII of Dodd-Frank to cross-border activities. The SEC proposed specific rules to address cross-border activities involving security-based swaps, in addition to interpretive guidance, and recently adopted its first set of cross-border rules and interpretive guidance. Although this approach takes more time, we believe it has a number of benefits. These benefits include a full articulation of the rationales for particular approaches and consideration of alternatives to them, as well as a qualitative and quantitative assessment of the potential economic impacts, including the costs and benefits, of applying the SEC's rules on security-based swaps in the cross-border context. This assessment includes consideration of the rules' effects on competition, efficiency, and capital formation.

Finally, I would note that even though the SEC and the CFTC have taken different procedural approaches, SEC staff studied the CFTC guidance and consulted very closely with CFTC staff in developing the approach. The initial set of cross-border rules are, for the most part, aligned with the CFTC's guidance.

2. **Has the SEC noticed liquidity shifts between U.S. and international derivatives markets since the CFTC adopted its guidance?**

<u>**Response:**</u> Title VII of the Dodd-Frank Act established a new regime for the oversight of the previously largely unregulated over-the-counter derivatives marketplace. As you know, the Dodd-Frank Act gave the Commission jurisdiction over security-based swaps and the CFTC jurisdiction over swaps. Throughout the implementation of the Dodd-Frank Act, SEC staff has had many discussions with market participants and intermediaries. In addition, consistent with the Dodd-Frank Act, SEC staff has consulted and coordinated closely with the CFTC and with foreign regulatory authorities. For example, the staffs of both the SEC and the CFTC participate in a number of international working groups addressing OTC derivatives issues.

Over the last year, market participants and other regulators have indicated that there have been shifts in liquidity, which some have suggested are in reaction to the CFTC being the first to implement new regulation of the previously largely unregulated global market place for OTC derivatives. The Financial Stability Board's *OTC Derivatives Market Reforms: Seventh Progress Report on Implementation* discusses the issue of restructuring but notes that: "it is not clear whether moves to reorganize activity – and the consequence of this – are temporary issues that can be corrected as more jurisdictions implement their reforms, or whether they will lead to longer-run market reorganization."[1] Moving forward with recommendations for adoption of additional Title VII-related rules, the staff will pay close attention to the state of the OTC derivatives markets, including any effects of rules promulgated by other regulators.

3. **How can U.S. entities follow both a rule and guidance?**

<u>**Response:**</u> Regulatory authority over derivatives is divided between the SEC and the CFTC, with the SEC having authority over security-based swaps, the CFTC having authority over swaps, and the SEC and CFTC jointly regulating mixed swaps. The SEC also has enforcement authority over "security-based swap agreements," which are securities-related swaps subject to the CFTC's regulatory authority (e.g., a swap on the S&P 500 index).

The CFTC's interpretive guidance and policy statement provides insight to market participants regarding how the CFTC interprets its rules and governing statute in the cross-border context for swaps. The SEC's cross-border rules and interpretive guidance address security-based swaps. Moreover, different statutory provisions govern the CFTC's and SEC's regulatory authority over activity that occurs outside the United States. And the statutory provision governing the CFTC's authority over activity outside the United States differs from the SEC's provision in that the former is self-executing. Accordingly, no rulemaking is required for the CFTC's rules to apply to activities outside

[1] Financial Stability Board, *OTC Derivatives Market Reforms: Seventh Progress Report on Implementation*, 8 April 2014, available at http://www.financialstabilityboard.org/publications/r_140408.pdf.

the United States. By contrast, the statutory provision governing the SEC's authority to reach activities outside the United States expressly requires rulemaking.

The Dodd-Frank Act calls on the agencies to treat functionally or economically similar products or entities in a similar manner, but does not require identical rules. At the same time, the Dodd-Frank Act calls on the Commission and the CFTC to consult and coordinate for the purposes of assuring regulatory consistency and comparability to the extent possible. The staff's efforts since the Dodd-Frank Act was enacted in July 2010 have been guided by these imperatives.

The cross-border rules and interpretive guidance the SEC adopted in June represent a careful balancing of the regulatory goals of Title VII, the practical needs of market participants, and workability with the existing CFTC regime. For the most part, the SEC rules are aligned with the CFTC's guidance. As a result, we believe that market participants subject to both SEC rules and interpretive guidance and CFTC guidance should be able to follow both frameworks.

**Rep. Steve Stivers**
**Question for Mr. Luparello**
**Hearing entitled "Oversight of the SEC's Division of Trading and Markets"**
**Thursday, June 26, 2014 9:15 AM**
**Capital Markets and Government Sponsored Enterprises**

**Mr. Luparello:**

**There are many regulatory reporting systems currently in place, including, but not limited to, OATS, EBS, LTID, LOPR, Short Interest, AES, and INSITE. The SEC is also currently overseeing the creation of the Consolidated Audit Trail (CAT), a comprehensive and costly regulatory reporting system. In addition to these eight systems, FINRA has now proposed building another system called the Comprehensive Automated Risk Data System (CARDS), which tracks some of the same information and have some overlap with the other systems mentioned above.**

**In my conversations with different stakeholders, it is my current understanding that CARDS will cause duplicity and higher costs by tracking the following information other regulatory reporting systems currently track or will soon track. Those areas of duplicity include partial or substantial overlap in:**

1) **customer account types;**
2) **beneficial owners;**
3) **registered persons;**
4) **purchase and sale activity;**
5) **account balances; and**
6) **security reference data.**

1. **What is the rationale and justification for the CARDS system when the CAT system has not been built yet, and CAT will collect much of the data that CARDS is now intending to collect?**

   Response: FINRA has not submitted a proposed rule change to the SEC regarding CARDS; therefore, SEC staff does not know what the final terms of and justification for CARDS will be. However, FINRA staff has indicated to SEC staff that FINRA will map CARDS data requirements to CAT data requirements to assure that there will not be an overlap between the data collected by the two systems. FINRA staff has further stated that they would like to harmonize CARDS with the CAT and any other existing data collection processes and mechanisms to avoid duplicating the collection of information.

2. **What plans does the SEC have to take a hard look at the litany of expensive existing and planned regulatory reporting systems to fully leverage these systems and avoid costly duplication?**

**Response:** The SEC is cognizant of the need to avoid redundant regulatory reporting systems. For example, the SEC rule requiring the development of the CAT NMS plan requires the self-regulatory organization ("SROs") to, among other things, develop "a plan to eliminate existing rules and systems (or components thereof) that will be rendered duplicative by the consolidated audit trail . . . ." Further, to the extent that the SROs determine that any existing system is not rendered duplicative by the CAT, the rule generally requires the SROs to address whether the collection of information by such system remains appropriate; whether such information should continue to be separately collected or should instead be incorporated into the CAT; and if the information is no longer appropriate, how the collection of such information could be effectively terminated.

3. **Can you address the impact to competition of multiple regulators building duplicative regulatory reporting systems, the costs of which mid-sized and smaller broker dealers shoulder?**

**Response:** While requiring broker-dealers to report to multiple regulators operating disparate systems is burdensome, because multiple regulators will have access to the CAT data, the creation of the CAT should result in efficiency gains for market participants with respect to their regulatory data reporting requirements and for regulators with respect to their surveillance activities. In addition, implementation of the CAT could render existing rules and systems that contain the same requirements as the CAT redundant.

As described above, SEC rules require the SROs to provide a plan to eliminate existing rules and systems (or components thereof), including identification of such rules and systems (or components thereof), and also consider whether collections of information that are not duplicative of the CAT are still appropriate and if so, whether they could be incorporated into the CAT. I believe that these requirements to examine how to eliminate redundant system should help to reduce costs for broker-dealers that are currently required to report to multiple systems.

4. **What checks and balances are you using to determine if multiple systems cover the same space?**

**Response:** New systems proposed by the SROs are required to be filed as proposed rule changes with the SEC under the Exchange Act and must be approved before they can be implemented. Each proposed rule change is subject to a notice and comment period. During this period, interested parties may inform the SEC if the proposed rule change is duplicative of an existing system and present any reasons why the proposed system is unnecessary. Upon receipt of such a comment, SEC staff would request that the SRO respond to the arguments made by the commenter. This information is then part of the record for the Commission's consideration of whether the proposed rule change is consistent with the Exchange Act and therefore should be approved.

**5. Does the SEC intend to make sure that these new systems do not impose unnecessary cost on the industry and ultimately the consumer?**

**Response:** As stated in response to the prior question, the SROs are required to file a proposed rule change with the SEC before implementing a new system. Every proposed rule change must include information that the Commission can use to make a determination that the proposed rule change is consistent with the Exchange Act. In particular, an SRO must state in proposed rule changes whether the proposed rule change will have an impact on competition and, if so, whether the proposed rule change will impose any burden on competition and the particular categories of persons and kinds of businesses on which any burden will be imposed as well as the ways in which the proposed rule change will affect them. In addition, as described in response to the prior question, each proposed rule change is subject to a notice and comment period, during which the SEC may receive industry feedback on a proposed rule change. During this period, interested parties can raise concerns they have with a proposal, including whether the potential benefits of a proposal do not justify the potential costs.