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;

[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

---

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

---

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.

---

[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]

---

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.