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SEC Chair White Speech on Market Structure Issues

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 9-14
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 12-14
CLOSED-END INVESTMENT COMPANY MEMBERS No. 20-14
SEC RULES MEMBERS No. 20-14 RE: SEC CHAIR WHITE SPEECH ON MARKET STRUCTURE ISSUES

On June 5, SEC Chair White gave a speech, “Enhancing our Equity Market Structure,” that outlines her views on a number of market structure issues. Specifically, the speech covers five sets of issues: market instability, high frequency trading, fragmentation, broker conflicts, and the quality of markets for smaller companies.

Market Instability

Chair White discusses a number of initiatives undertaken by the SEC to address concerns regarding the risk of instability and disruption in the markets including the “limit up-limit down” rules, market-wide circuit breakers, market access rule, Regulation SCI, and measures taken to address issues relating to certain market infrastructure systems that are “single points of failure.”

Chair White notes that while considerable progress has been made in addressing the risk of market instability, there is more to be done in this area. She does not, however, outline any forthcoming SEC initiatives to further address market instability.

High Frequency Trading

The speech outlines a number of initiatives relating to the current use of algorithms and high frequency trading. Specifically, Chair White states that she has asked the SEC staff to prepare recommendations for the Commission in a number of areas including:

- developing an “anti-disruptive trading rule” to address concerns regarding the use of aggressive, destabilizing trading strategies in “vulnerable” market conditions;

- developing rules to clarify the status of unregistered active proprietary traders to subject them to SEC rules as dealers and to eliminate an exception from FINRA membership requirements for dealers that trade in off-exchange venues; and
- improving firms' risk management of trading algorithms and enhancing regulatory oversight over their use.

Chair White also discusses fairness concerns regarding the latency difference between the markets' direct data feeds and consolidated feeds. She states that as initial steps to address these issues, the SEC will continue to focus on the efforts of exchanges and FINRA in minimizing consolidated data latency. She also states that she is asking the exchanges and FINRA to consider including a time stamp in the consolidated data feeds that indicates when a trading venue, for example, processed the display of an order or execution of a trade. In addition, Chair White states that she is asking the exchanges to develop proposed rule changes to disclose how, and for what purpose, they are using data feeds to allow brokers and investors to better assess the quality of an exchange's execution and routing services.

Finally, Chair White states that we must consider whether the "search for speed" has passed the point of diminishing returns. While she states that she is personally wary of prescriptive regulation that attempts to identify an optimal trading speed, she is receptive to more flexible, competitive solutions that could be adopted by trading venues such as frequent batch auctions or other mechanisms designed to minimize speed advantages including affirmative or negative trading obligations for high-frequency trading firms that employ the fastest, most sophisticated trading tools.

Fragmentation, Enhancing Market Transparency and Examining Trading Venue Regulation

Another area discussed in the speech is the proliferation of trading venues and related concerns regarding their interconnectedness, i.e., the potential for one or more systems to malfunction and disrupt other systems or to interact with other systems in unexpected ways, and the increase in the percentage of order flow that is handled and executed by dark trading venues.

Chair White specifically notes concerns regarding the lack of transparency in dark trading venues. She therefore supports FINRA expanding its recently adopted requirements for the dissemination of aggregate information of trading volume on ATSS to other dark venues including off-exchange market makers and other broker-dealers. Chair White also has asked the SEC staff to prepare a recommendation to the Commission to expand the information about ATS operations submitted to the SEC and to make such information available to the public.

Chair White notes that the SEC also is continuing to consider whether more fundamental changes are needed to bring the current regulatory structure in line with significant market changes including considering whether the SEC's own rules, such as the trade-through rule of Regulation NMS, have contributed to excessive fragmentation across all types of venues. Finally, Chair White states that the SEC will be considering whether the current regulatory model for exchanges and other trading venues makes sense for today's markets.

Broker Conflicts

The speech addresses several issues relating to broker conflicts and how they are exacerbated or mitigated by different trading venues. Chair White notes that most investors rightly rely on their brokers to navigate the markets on their behalf but monitoring the execution quality and costs of orders can be difficult for even the most sophisticated investors, given the number of trading venues and order types available to brokers. She adds that when payments made to brokers by trading venues in connection with attracting particular types of order flow are not passed through from brokers to customers, they can create conflicts of interest and raise serious questions about whether such conflicts can be effectively managed.

As a step to address these issues, Chair White states that she has asked the SEC staff to prepare a recommendation to the Commission for a rule that would enhance order routing disclosures by requiring disclosure of the customer-specific information that a broker is expected to provide to each institutional customer on request. She notes that while some brokers already voluntarily provide some of this information, a rule is necessary to ensure that the disclosed information is useful, reliable, and uniformly available on request to all institutional customers.

Finally, Chair White notes that another source of broker conflicts is the large number of complex order types offered by the exchanges. She is therefore asking the exchanges to conduct a comprehensive review of their order types and how they operate in practice and that as part of this review, she expects that the exchanges will consider appropriate rule changes to help clarify the nature of their order types and how they interact with each other, and how they support fair, orderly, and efficient markets.

Quality of Markets for Smaller Companies

Chair White states that in enhancing market structure, we must focus closely on the particular needs of smaller companies and their investors. She specifically notes the SEC's development of a pilot program to allow for wider tick sizes for the stocks of smaller companies. She states that she anticipates that the Commission will soon complete its review of the terms of such a pilot.

Market Structure Advisory Committee

Chair White has recommended the creation of a new Market Structure Advisory Committee of individuals to review specific initiatives and rule proposals. The new committee will serve as an additional forum and resource for reviewing specific, clearly articulated initiatives or rule proposals.

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