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Litigation Alert

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SEC Chair Describes Sweeping Initiatives To Reform Market Structure And Increase Transparency

In a speech delivered on June 5, 2014 at the Sandler O'Neill Global Exchange and Brokerage Conference in New York, U.S. Securities and Exchange Commission (SEC) Chair Mary Jo White unveiled a package of SEC initiatives aimed at reforming the nation's equity markets and increasing transparency for investors. While noting that the "[t]he current market structure is not fundamentally broken," White said that the SEC is conducting a "comprehensive review" of the investment environment and provided unusual detail about five areas that the SEC is focused on: (1) market stability, (2) high-frequency trading, (3) trading fragmentation, (4) broker conflicts, and (5) markets for small companies. The proposals White outlined, if adopted, would impact market participants of all types, including exchanges, alternative trading venues, clearing firms, broker-dealers, and investment advisers.

Market Stability

The SEC already had taken steps to minimize disruption from the use of technology in the equity markets by introducing circuit breakers and the Market Access Rule, which imposes technology risk controls on brokers. According to White, the SEC will soon finalize Regulation SCI, which will impose similar controls on exchanges, clearing firms, and alternative trading systems. Although not mentioned by White, the SEC also recently began a cybersecurity sweep of investment advisers and broker-dealers to assess their technology infrastructure. The agency's focus in this area highlights the need for market participants to take stock of their technology systems and their oversight over those systems.

High-Frequency Trading

In recent years, the equity markets have been dominated by algorithmic trading, which White said likely represents today "well over a majority of trading volume." White acknowledged that investors have benefitted from the "algorithmic marketplace" by way of reduced volatility and trading costs but outlined several proposals to update the regulatory regime to address the new reality. The SEC plans to introduce rules requiring greater risk management of trading algorithms and limiting "aggressive, destabilizing" high-speed trading in periods of increased volatility. The agency is also considering broad measures "to minimize speed advantages," including requiring the exchanges to further reduce the latency between the direct data feeds that high-frequency traders use and the consolidated feed that is publicly available. And it plans to subject unregistered active proprietary traders to SEC registration as dealers and off-exchange dealers to FINRA membership. White's remarks indicate that increased oversight of high-speed trading is an important item in the SEC's rulemaking agenda.

Trading Venue Regulation

White noted the proliferation of alternative trading venues in recent years and the significant volume now handled by private platforms known as dark pools, which offer limited transparency of their operations and the identity of their participants. According to White, the distinction between traditional exchanges and alternative venues has substantially blurred in recent years. The SEC is therefore considering extending FINRA disclosure rules to off-exchange market makers and broker-dealers. In coming months, dark pools and other alternative trading venues can expect to see important changes to the level of transparency required of them.

Mitigating Broker Conflicts

White said that conflicts of interest between brokerage firms and their clients can be exacerbated by brokers' receipt of fees and rebates from trading venues for directing order flow. The SEC plans to require greater disclosure about these arrangements as well as increased clarity by exchanges and other trading venues about the order types they offer. While brokers' conflicts of interest have long been an area of focus for the SEC's enforcement program, White's remarks suggest that the agency intends to enhance the level of transparency required in this area.

Smaller Companies

Finally, White noted the decline since the 1990s in the number of domestic companies listed on U.S. exchanges, and added that the SEC plans to address the needs of smaller companies and their investors. The agency will soon launch a pilot program to allow small capitalization stocks to trade with wider tick ranges in order to improve liquidity and attract market makers to this segment of the equity markets.

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The reform package that Chair White outlined includes recommendations that will soon become SEC rules as well as proposals that remain tentative at this stage. Nonetheless, White's remarks make clear that market participants can expect to see significant changes in the coming months to the investment environment in the equity markets.

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