The Regulatory Landscape – Current Regulatory Proposals and the Issues Raised

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Overview

A. Market Structure Issues

B. Market Data Issues

C. Financial Regulatory Reform

D. Capital Formation Proposals

E. May 6 Market Events

F. Mutual Recognition

A. Market Structure Issues

- (1) Dark Pools/Indications of Interest (IOIs), (2) Flash Orders, (3) Co-Location, High Frequency Trading, (4) Consolidated Audit Trail, (5) Recently Approved Actions; and (6) SRO Market Structure Filings.
- Note that many equity market structure issues were addressed in the SEC's Equity Market Concept Release.

Flash Orders

- The proposed rule was approved by the SEC Commissioners on September 17, 2009. The proposed rule: (1) Eliminates an exception for the use of flash orders by markets; (2) Requested public comment and data on a broad range of issues relating to flash orders; (3) Requested comment on whether the use of flash orders in the options markets should be evaluated differently than their use in the equity markets.

- The SEC reopened the comment period on July 2, 2010 for the proposed elimination of the flash order exception with respect to listed options. Additional comment is requested on the effect of a proposed cap on access fees for listed options, and on the execution quality that flash orders receive in the options markets. Comments were due by August 9, 2010.

Dark Pools

- The proposed rule, approved by SEC Commissioners on October 21, 2009 had a comment period that ended on February 22, 2010. The rule would:
- Require actionable IOIs [indications of interest] to be treated like other quotes and subject to the same disclosure rules.
- Lower the trading volume threshold applicable to alternative trading systems for displaying best-priced orders to 0.25%, for ATSs, including dark pools that use actionable IOIs.
- Create the same level of post-trade transparency for dark pools – and other ATSs – as for registered exchanges (i.e., amend existing rules to require real-time disclosure of the identity of the dark pool that executed the trade).
- On May 20, 2011, note that the Technical Committee of the International Organization of Securities Commissions (IOSCO) published a final report, Principles on Dark Liquidity, containing principles to assist securities markets authorities in dealing with issues concerning dark liquidity.

High Frequency Trading/Co-Location

- Although there is no proposed rule on co-location or high frequency trading, the Commission is looking at these issues.
- Both are addressed in the SEC Equity Market Concept Release, in which the Commission proposes questions relating to how these issues benefit the long term investor. Both have been raised at SEC Open Meetings and Staff has indicated that these market issues could come in the form of proposals.
- The CFTC is looking at this issue, through its Technology Advisory Committee. On February 9, 2012, the Commodity Futures Trading Commission (CFTC) voted to establish a new Subcommittee of the Technology Advisory Committee to focus on Automated and High Frequency Trading ("HFT"). This subcommittee, to be chaired by CFTC Chief Economist Andrei Kirilenko is tasked "with developing recommendations regarding the definition of high frequency trading in the context of the larger universe of automated trading."
- The Senate Permanent Subcommittee on Investigations (PSI) began investigating high frequency trading practices (even holding a hearing in December 2010 that included this subject). Though there is some uncertainty as to outcome of this investigation.
- **High Frequency Trading:** In March 2012 it was announced (in press reports) that the SEC has launched a "broad investigation" into whether exchanges favor large trading companies at the expense of smaller customers. The investigations are focusing on whether operators use multiple exchanges to appease customers which provide large order flows allowing them to grant advantages to some customers by using different rules on different exchanges.
- **Order Cancelation**: In March 2012 it was announced (in press reports) that Nasdaq and Direct Edge will impose penalties on high-frequency traders who "clog" the markets' data pipelines with "unnecessary messages that do not result in trades." Similar proposals have been announced by Deutsche Borse and Borsa Italiana. Nasdaq penalties will range from 0.01 cents to 1 cent per trade for traders who send over 1 million messages per day but generate fewer than 1 trade per 100 messages. Direct Edge's program will target any customer whose trade-to-message ratio is less than 1 to 100 and those who exceed the ratio will receive lower rebates to place quotes.

Consolidated Audit Trail

- On May 26, 2010, the Securities and Exchange Commission (SEC) unanimously voted to propose that self-regulatory organizations (SROs) establish a consolidated audit trail system that would require (among other requirements) that "every exchange and FINRA, as well as their respective members, to provide certain detailed information to a newly created central repository regarding each quote and order in an NMS security and each reportable event with respect to each quote and order."
- Note that the central repository would be jointly owned and operated by the exchanges and FINRA, and that the exchanges, FINRA and the SEC would have access to the data collected by the central repository. The proposed rule would provide for a phased approach to implementation, requiring: (1) "the Exchanges and FINRA to submit an NMS plan to the Commission within 90 days of approval of the proposed rule;" (2) "the Exchanges and FINRA to provide to the central repository the required data within one year after effectiveness of the NMS plan;" and (3) "members of the Exchanges and FINRA to provide to the central repository the required data within two years after effectiveness of the NMS plan."
- The SEC estimates the cost for the initial implementation of the consolidated audit trail at approximately $4 billion, which includes the estimated costs to be incurred by the SROs and member firms. For member firms with their own internal order management systems, the SEC estimates that the average one-time initial cost per member would be approximately $1.5 million. The SEC further estimates the costs for maintaining the consolidated audit trail system at $2 billion annually for the SROs and member firms. The details as to how costs will be allocated across the industry are yet to be determined.

Consolidated Audit Trail

- Note that the SEC-CFTC Advisory Committee on Emerging Regulatory Issues recommended that the SEC proceed with a sense of urgency, and a focus on meaningful cost/benefit analysis, to implement a consolidated audit trail for the US equity markets and that the CFTC similarly enhance its existing data collection regarding orders and executions

- On February 24, 2012, SEC Chairman Mary Schapiro stated that the contours of the regulation are being finalized and will be considered by the full Commission. "In addition, while the initial proposal will be for an audit trail tracking orders and trades in the equity markets, I believe that the system should eventually be expanded to include fixed income, futures and other markets…We expect to adopt a final rule in the months ahead. After that, I anticipate that the exchanges and FINRA will be required to submit a detailed blueprint, which in turn would be subject to public comment and a separate Commission approval."

Recently Approved Actions

- **Large Trader Reporting**: On July 26, 2011, the Securities and Exchange Commission (SEC) unanimously approved 5-to-0 a rule on a "large trader reporting system." The rule became effective on October 3, 2011 and compliance for large trader registration was December 1, 2011 and compliance for broker-dealers to maintain records and monitor trading activity is April 30, 2012. Chairman Mary Schapiro stated that the Commission was establishing a " large trader reporting system" to identify large traders and collect information on their trading activity. She stated that a "large trader" would generally be defined "as a person, including a firm or individual, whose transactions in exchange-listed securities equal or exceed (i) two million shares or $20 million during any calendar day, or (ii) 20 million shares or $200 million during any calendar month."

- **Listed Options: Fees and Access**: On April 14, 2010, the Securities and Exchange Commission (SEC) held an open meeting, in which the Commissioners unanimously approved 5-to-0 a proposals on "listed options." The proposal's comment period ended on June 21, 2010. The proposal on listed options, according to Chairman Mary Schapiro, "would put in place two measures in options markets which currently exist in stock markets." These included: (1) a prohibition of an options exchange "from unfairly limiting access to [it] by non-members seeking to access quotations through members"; and (2) a limitation on the fees (to $0.30 per-contract) "an options exchange can charge investors and others wishing to access a quote on its exchange."

Recently Approved Actions

- **Short Sales:** SEC Commissioners Approved the Final Rule on February 24, 2010 in 3-to-2 vote. The rule became effective May 10, 2010 but on November 4, 2010, the Securities and Exchange Commission (SEC) extended the date for compliance with the SEC's short sale rule (Rule 201, which would restrict the prices at which a stock can be sold short if the stock's price drops 10 percent or more in one day) from November 10, 2010 to February 28, 2011. The rule would apply to all equity securities listed on national securities exchanges (traded on the exchange or in the OTC market) and require trading centers "to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent the execution or display of a prohibited short sale."

- **Sponsored Access:** The SEC Commissioners unanimously approved a final rule on sponsored access on November 3, 2010. Known as Rule 15c3-5, this rule will require brokers and dealers to impose certain risk controls before providing their customers with access to the market. There will be limited exceptions to permit a broker or dealer to "reasonably allocate certain controls and procedures to another registered broker or dealer that, based on its position and relationship with the ultimate customer, can more effectively implement them." Rule 15c3-5 became effective January 14, 2011 and broker-dealers became subject to the rule on July 14, 2011.

SRO Market Structure Filings

- **NYSE Retail Liquidity Program:** On October 19, 2011, the NYSE filed a proposal with the SEC proposing to establish a Retail Liquidity Program on a pilot basis, limited to trades occurring at prices equal to or greater than $1.00 per share. According to the Exchanges, the Retail Liquidity Program is intended to attract retail order flow to the NYSE for NYSE-listed securities and to NYSE Amex for NYSE Amex-listed securities as well as securities listed on the Nasdaq Stock Market and traded pursuant to unlisted trading privileges. The proposed Retail Liquidity Program would allow such order flow to receive potential price improvement. On February 7, 2012, the SEC instituted a proceeding to see whether the rule should be disapproved. Comment period closed on March 5, 2012 and the rebuttal period closed on March 19, 2012. On February 16, 2012 the NYSE filed a partial amendment to the proposed Retail Liquidity Provider program: (1) limit the definition of "Retail Order"; (2) modify the definition of the Retail Liquidity Identifier; and (3) clarify the treatment of odd lots, round lots, and part of a round lot orders.

- This proposal seems to be an attempt by NYSE to take market share from dark pools, internalizers and high frequency traders.

- Meanwhile, the Nasdaq appears to be talking to the Hill to attempt to get the SEC to implement a "trade at" rule and other market structure changes as part of small business capital formation legislation (see pages 12, 22, and 23).

Market Structure

- Other potential modifications to equity market structure have arisen in the context of capital formation legislation, notably in the House (H.R. 3606). As noted within this presentation, several amendments to this bill were considered during a House Financial Services Committee markup in February 2012. Only Representative David Schweikert's (R-AZ) amendment on the SEC Decimalization Study was approved by the Committee.

- In addition, some market structure related amendments were discussed but later withdrawn. Representative Jim Renacci (R-OH) offered an amendment that would have permitted emerging growth companies to designate that its securities that are not traded on an exchange "be executed at a price that is superior to the best prices displayed by any national securities exchange" (e.g. "trade-at"). Separately, Representative Patrick McHenry (R-NC) offered and then withdrew an amendment that would permit an exchange to adopt a program under which an emerging growth company provides financial incentives to market makers.

B. Market Data

NetCoalition

- In May 2006, NYSE Arca filed a proposed rule change with the Securities and Exchange Commission (SEC) to begin charging a fee to investors for access to its proprietary "depth-of-book" product, ArcaBook.
- The SEC approved NYSE Arca's proposal in 2008, finding the proposed fees for ArcaBook were "fair and reasonable" and "not unreasonably discriminatory." Soon after, NetCoalition and the Securities Industry and Financial Markets Association (SIFMA) filed a case in the United States Court of Appeals, District of Columbia Circuit challenging the SEC order, arguing that it violated the Securities Exchange Act of 1934 and the Administrative Procedure Act.
- On August 6, 2010, the U.S. Court of Appeals for the District of Columbia Circuit vacated and remanded the 2008 SEC Order, concluding that the SEC "did not adequately explain the basis of its approval nor, on this record support its conclusion with substantial evidence."
- **Competition:** The SEC has claimed that "it obviously would be inappropriate for the Commission to rely on non-existent competitive forces as a basis for approving an exchange proposal." In the NetCoalition case the Court claimed that information relating to the cost of collecting and distributing market data is "directly relevant to whether an exchange is able to charge a market-based rate or a supracompetitive rate for ArcaBook." The costs incurred in collecting and distributing depth-of-book data itself are relevant in assessing the reasonableness of the fees an exchange charges for the data because "in a competitive market, the price of a product is supposed to approach its marginal cost."

Market Data

Substitutes

- In the *NetCoalition* case, NYSE Arca claimed that there are several "substitutes" for the depth-of-book data that would constrain an exchange's exercise of market power, for example: core data; other depth-of-book data provided by other exchanges; "pinging" orders; and the threat of independent distribution of order data by securities firms and data vendors acting in concert.

- In its ruling the D.C. Court held that "the SEC had insufficient evidence before it to conclude that a trader interested in depth-of-book data would substitute any of the four alternatives (or simply do without) instead of paying a supracompetitive price." According to the D.C. Court, the test for whether there are substitutes for a product is whether users will switch when faced with a 'small but significant non-transitory increase in price,' generally assumed to be around 5%. In the case of AcraBook, depth-of-book data is unique to each individual exchange, so in order for a trader to have a comprehensive picture of liquidity below the top of the book they need depth-of-book data from all the exchanges with substantial trading. This suggest that market data substitutes do not actually exist and an SRO with a significant share of trading in an NMS stock could exercise market power in setting the fees for its market data.

Market Data

- In September 2010, NASDAQ and NASDAQ OMX PHLX filed proposed market data fee changes to their distributor and direct access fees for depth-of-book proprietary data products.
- In November 2010, NYSE Arca re-filed a proposal to authorize market data fees for the receipt and use of depth-of-book market data that NYSE Arca makes available.
- Each of these filings cited section 916 of the Dodd-Frank Act, which streamlines the SRO rule filing process as a rationale for approving the market data fee changes, notwithstanding the decision by the D.C. Circuit.
- The SEC has yet to take action on the Court ruling or on the subsequent proposed rule changes, allowing the SRO's to charge the new fees for market data.
- Section 916 of the Dodd-Frank Act, the Exchange Act allows for SRO fee proposals to become effective immediately upon filing. Within 60 days from the date of filing of a proposed rule change, the SEC "may temporarily suspend" the change in the rules of the SRO, if such action "is necessary or appropriate in the public interest, for the protection of investors." "If the Commission takes such action, the Commission shall institute proceedings…to determine whether the proposed rule should be approved or disapproved."
- As a result, NetCoalition and SIFMA continue to challenge recent market data fee increases by Nasdaq and NYSE.
- On December 16, 2011, the SEC filed a brief in response to NetCoalition's and SIFMA's request to the DC Circuit to seek a review of the "absence of action" by the SEC (the non-suspension of fee rates for access to market data charged by NYSE and Nasdaq).

Market Data

- The SEC argued that: (1) a judicial determination that the Commission was required to suspend the fees and begin an approval or disapproval proceeding would interfere with the Congressional decision to permit the Commission to decide whether to use resources for that purpose or for other purposes; (2) there is "no qualifying language" in this case that requires a determination that the fees comply with the statutory requirements "before they may take effect – rather, they take effect upon filing, though they may thereafter be enforced only to the extent not inconsistent with the law"; (3) the "mere existence of a dispute" about whether a rule is permitted "cannot give rise to the obligation to suspend"; (4) "[i]nvalid fees, like all rules that are inconsistent with the Exchange Act, cannot be enforced by the SRO"; and (5) the statute imposes "no affirmative obligation on the Commission to determine whether the fees comply with the law before they may take effect."
- **Nasdaq and Market Data:** The Nasdaq Stock Market separately filed a proposed rule change in January 2011 relating to market data fees, but this time tying it to order flow. The proposal would reduce market data fees and transaction execution fees for retail investors, providing three different tiers of discounts for its depth-of-book products and an enhanced liquidity provider rebate based upon the extent to which a member both consumes Nasdaq market data and provides liquidity. On January 28, 2011, the SEC temporarily suspended this proposed rule and instituted proceedings to determine whether to approve or disapprove of the rule. On February 11, 2011, NASDAQ proposed on a temporary basis (which sunset on April 30, 2011) to revise an optional Depth Data Enterprise License Fee for broker-dealer distribution of depth-of-book data to non-professional users with which the firm has a brokerage relationship. Effective March 1, 2012, NASDAQ was to offer a voluntary Enterprise License for non-professional usage of "NASDAQ Depth Data" that was identical to those offered previously. But without notice, the SEC rejected this proposal.

C. Financial Regulatory Reform

- Market Structure/ other SEC-related issues addressed in the financial regulatory reform legislation (H.R. 4173- Dodd-Frank Wall Street Reform and Consumer Protection Act). The legislation became law in July 2010.
- Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) have weighed in and should have a significant influence on market structure issues, as envisioned by the financial reform legislation.
- The major issue going forward in implementing the rules under the Dodd-Frank Act will be whether the agencies have the budget to enforce the new rules. Already, the agencies have been under increased oversight from Congress and facing smaller budgets.

Financial Regulation (General)

- Created a Financial Stability Oversight Council (FSOC) to identify and regulate financial firms that are large, interconnected, or systemically risky.
- Established an orderly process for dismantling large, failing financial institutions (e.g., dissolution authority and ending "Too Big to Fail").
- All standardized swap transactions between dealers and "major swap participants" have to be cleared and traded on an exchange or electronic platform.
- In regards to credit rating agencies, reduces conflicts of interest and market reliance. There is some conflict with the Basel Committee requirements.
- Created a Bureau of Consumer Financial Protection within the Federal Reserve, with authority to write consumer rules.

Financial Regulation: SEC

- SEC conducted a study on fiduciary duty and has the authority to impose a fiduciary duty on brokers who give investment advice.
- Creates a program within the SEC to encourage people to report securities violations.
- Mandates a comprehensive outside consultant study of the SEC, an annual assessment of the SEC's internal supervisory controls and GAO review of SEC management (Boston Consulting Group Study-March 2011)
- Gives shareholders a "say on pay" – an advisory vote on pay practices including executive compensation and golden parachutes.
- Requires almost all advisers to private pools of capital to register with the SEC, and they will be subject to systemic risk regulation by the Financial Stability regulator.
- **Procedural Rules for SRO Filings:** The Commission adopted new Rules of Practice to formalize the process it will use when conducting proceedings to determine whether an SRO's proposed rule change should be disapproved. The new rules are intended to add transparency to the Commission's conduct of those proceedings, to address the process the Commission will follow to institute proceedings and provide notice of the grounds for disapproval under consideration, and to provide interested parties with an opportunity to submit written materials to the Commission.
- **Conflicts of Interest:** Requires a GAO study on the conflicts of interest between investment banking and equity and fixed income security analyst functions and make recommendations to Congress within 18 months of enactment. (Section 919A) This study was completed in January 2012. The GAO recommended that the SEC formally assess and document whether any of the Global Settlement's remaining terms should be codified and the SEC agreed with the recommendation.

Financial Regulation: SEC

- **Investor Access:** Requires a SEC study within 6 months of enactment on improving access to information on investment advisers and broker dealers (which was completed in January 2011). The SEC is to implement any recommendations of the study within 18 months of its completion. (Section 919B).
- **Ownership/Profit Reporting:** The SEC is authorized to adopt rules that would require more timely reporting (10 days or less) when a person acquires more than 5% ownership interest in an issuer ("beneficial ownership") or makes a short-swing profit. (Section 929R)
- **SEC Study and Report on Short Selling:** The SEC shall conduct (i) a study on the state of short selling with particular attention to the impact of recent rulemaking and the incidence of the failure to deliver shares sold short or delivery on the fourth day following the short sale transaction and (ii) a study of the feasibility and cost-benefits analysis of requiring real time reporting of short sale positions of publicly listed securities to the public or to the SEC and FINRA, and the feasibility and cost-benefits analysis of a voluntary pilot program where public companies will agree to have all trades of their shares marked "short", "market maker short", "buy", "buy-to-cover", or "long", and reported in real time through the Consolidated Tape. The first study should be reported to Congress not later than 2 years after enactment and the second study should be reported not later than 1 year after enactment. (Section 417) Note that the SEC on May 4, 2011, requested comment on their study on short sales. Though the SEC was required to submit its study on the short sales on July 21, 2011, it has yet to release it.
- **Short Sale Disclosures:** The SEC must adopt rules requiring financial institutions filing reports (at least monthly) to disclose information regarding short sales, including the name of the issuer and the title, class, CUSIP number and aggregate amount of the number of short sales of each security. There is an explicit requirement to include manipulative short sales of any security and grants the SEC authority to adopt appropriate rules. Broker-dealers are required to notify their customers that customers may elect not to allow their fully paid securities to be used in connection with stock lending by the broker-dealer. (Section 929X)

Financial Regulation: Revisited

- **SEC Cost-Benefit Analysis:** On June 23, 2011, Representative Scott Garrett (R-NJ) introduced H.R. 2308 the "SEC Regulatory Accountability Act" which seeks to amend the Securities Exchange Act of 1934 to require the SEC, before promulgating a regulation or issuing any order, to: (1) identify the nature and significance of the problem that the proposed regulation is designed to address in order to assess whether any new regulation is warranted; (2) use the Office of the Chief Economist to assess the costs and benefits of the intended regulation and adopt it only on a determination that its benefits justify the costs; and (3) ensure that any regulation is accessible, consistent, written in plain language, and easy to understand. On February 16, 2012, the House Financial Services Committee favorably reported this bill as amended in a voice vote.

- **Financial Regulator Cost-Benefit Analysis:** Senator Richard Shelby (R-AL), introduced S. 1615 the "Financial Regulatory Responsibility Act of 2011" on September 22, 2011, which seeks to hold financial regulators accountable for rigorous, consistent economic analysis on every new rule they propose. It requires them to provide clear justification for the rules, and to determine the economic impacts of proposed rulemakings, including their effects on growth and net job creation. This bill also improves the transparency and accountability of the regulatory process and reduces the burdens of existing regulations. In addition, the legislation mandates that if a regulation's costs outweigh its benefits, regulators are barred from promulgating the rule.

D. Capital Formation Proposals

- On March 8, 2012, the House Financial Services Committee approved "Reopening American Capital Markets to Emerging Growth Companies Act of 2011" (H.R. 3606), as amended. The bill would exempt "emerging growth companies" from certain disclosure requirements and from section 404(b) of the Sarbanes-Oxley Act. Emerging growth companies are those with total annual gross revenues of less than $1 billion. Such a company would continue to be an emerging growth company until the earliest of: (a) the end of the fiscal year in which gross revenues exceed $1 billion; (b) the fifth year after their IPO; or (c) the date on which the company is deemed to be a "large accelerated filer". A related bill, S. 1933, was introduced in the Senate by Senator Charles Schumer (D-NY) on December 14, 2011.

- One key amendment approved was Representative David Schweikert's (R-AZ) amendment, which would require the SEC to conduct a study of the impact of decimalization on IPOs since its implementation and the impact on liquidity for small and middle capitalization company securities. The amendment also provides that "[i]f the Commission determines that the securities of emerging growth companies should be quoted and traded using a minimum increment of greater than $0.01, the Commission may, by rule… designate a minimum increment" between $0.01 and $0.10 for the quoting and trading of these securities.

Capital Formation Proposals

- In addition, some market structure related amendments were discussed during a House Financial Services Committee markup on February 16, 2012, but later withdrawn after the Capital Market Subcommittee Chairman Garrett (R-NJ) indicated that these and other market structure issues would be the subject of a hearing sometime in the Spring. Representative Jim Renacci (R-OH) offered an amendment and suggested that changes to the structure of the U.S. equity market over the last decade have created a confusing marketplace, making it problematic for emerging growth companies. The amendment would have permitted emerging growth companies to designate that its securities that are not traded on an exchange "be executed at a price that is superior to the best prices displayed by any national securities exchange" (e.g. "trade-at"), and amends the Unlisted Trading Privileges rules to allow such companies to designate the time period for their shares to be traded only on the exchange. Separately, Representative Patrick McHenry (R-NC) offered and then withdrew an amendment that would permit an exchange to adopt a program under which an emerging growth company provides financial incentives to market makers.
- In 2011, the SEC established the Advisory Committee on Small and Emerging Companies to advise the SEC on its rules, regulations and policies as they relate to emerging companies or privately-held small businesses and publicly traded companies with less than $250 million in public market capitalization. The Advisory Committee has made recommendations on: improving access to public markets for small companies; registration requirements and reporting obligations; and modifying restrictions on general solicitation in certain private offerings.

E. May 6 Market Events

- On May 6, 2010, the financial markets experienced a brief but severe drop in prices, falling more than 5% in a matter of minutes, only to recover a short time later. The Securities and Exchange Commission and Commodity Futures Trading Commission established the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues to develop recommendations on emerging and ongoing issues relating to both agencies.

- On May 18, 2010, the SEC and CFTC staff released a report titled: "Preliminary Findings Regarding the Market Events of May 6, 2010." On October 1, 2010, the CFTC and SEC released the long-awaited report on the May 6 market events. The report, entitled "Findings Regarding the Market Events of May 6, 2010", cited as a cause a large fundamental trader (a mutual fund complex) initiating a sell program over 20 minutes to sell a total of 75,000 E-Mini contracts (valued at approximately $4.1 billion) as a hedge to an existing equity position as the culprit.

May 6 Market Events

Circuit Breaker Rules

- On May 19, 2010, the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) filed proposed rules under which they would pause trading in certain individual stocks in the S&P 500 for a five-minute period if the price moves 10 percent or more in a rolling five-minute period.

- On September 10, 2010, the Securities and Exchange Commission (SEC) approved "proposals by the national securities exchanges and FINRA to expand a recently adopted circuit breaker program to include all stocks in the Russell 1000 Index and certain exchange-traded funds."

- The SEC staff also considered other potential actions, including: (1) potential changes to different order types that may contribute to sudden volatility; (2) "studying the impact of other trading protocols at the exchanges"; and (3) whether market makers should be subject to more meaningful obligations to promote fair and orderly markets.

May 6 Market Events

Circuit Breaker Rules

- On September 27, 2011, the Securities and Exchange Commission (SEC) announced that the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) filed proposals "to revise existing market-wide circuit breakers." These circuit breakers when triggered, would "halt trading in all exchange-listed securities throughout the U.S. markets."

- This market-wide circuit breaker proposal would: (1) "reduc[e] the market decline percentage thresholds necessary to trigger a circuit breaker" to 7, 13, and 20 percent from the prior day's closing price; (2) "shorten[] the duration of the resulting trading halts that do not close the market for the day" to 15 minutes; (3) "simplify[] the structure of the circuit breakers to have only two trigger time periods," before 3:25 p.m. and on or after 3:25 p.m; (4) "us[e] the S&P 500 Index as the pricing reference to measure a market decline"; and (5) "provid[e] that the trigger thresholds are to be recalculated daily."

May 6 Market Events

Limit Up–Limit Down

- On April 5, 2011, the Securities and Exchange Commission (SEC) announced that national securities exchanges and the Financial Industry Regulatory Authority (FINRA) filed a proposal to establish a new "limit up-limit down" mechanism "to address extraordinary market volatility in U.S. equity markets." The limit up-limit down proposal "would prevent trades in listed equity securities from occurring outside of a specified price band, which would be set at a percentage level above and below the average price of the security over the immediately preceding five-minute period" (*e.g.*, 5 percent for stocks currently subject to the circuit breaker pilot, and 10 percent for those not subject to the pilot). Additionally, the percentage bands "would be doubled during the opening and closing periods, and broader price bands would apply to stocks priced below $1.00." For more fundamental price moves, "there would be a five-minute trading pause. . .if trading is unable to occur within the price band for more than 15 seconds."
- If approved, market participants would be required to "establish policies and procedures reasonably designed to prevent trades from occurring outside the applicable price bands, to honor any trading pause, and to otherwise comply with the procedures set forth in the plan." The proposed plan will have a 21-day public comment period, and then the Commission would determine whether to approve it "shortly thereafter." In February 2012 the SEC sent a request to the exchanges asking for additional time to consider the limit up-limit down proposal. The new deadline for Commission action is May 31, 2012.

May 6 Market Events

Uniform Clearly Erroneous Trades

- On September 10, 2010, the Securities and Exchange Commission (SEC) announced that it had approved the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) rules to clarify the process for breaking erroneous trades. These rules "set forth clearer standards for breaking trades and curtail the exchanges' discretion to select a different percentage threshold at which they would break trades."
- Under the rules, trades would be broken for stocks subject to single stock circuit breakers as follows:
  - Stocks priced $25 or less: Trades would be broken if they are at least 10 percent away from the circuit breaker trigger price.
  - Stocks priced more than $25 to $50: Trades would be broken if they are 5 percent away from the trigger price.
  - Stocks priced more than $50: Trades would be broken if 3 percent away from the trigger price.
- Where circuit breakers are not applicable, the exchanges and FINRA would break trades at specific levels for events where multiple stocks are involved. In the case of events involving between 5 and 20 stocks, trades would be broken for those at least 10 percent away from the reference price. For those involving more than 20 stocks, trades would be broken at least 30 percent away from the reference price.
- Pilot program extended until July 31, 2012.

May 6 Market Events

Stub Quote Prohibition

- On November 8, 2010, the Securities and Exchange Commission approved rules proposed by the exchanges and FINRA to strengthen the minimum quoting standards for market makers and effectively prohibit "stub quotes" in the U.S. equity markets. Effective on December 6, 2010, this rule would require continuous two-sided quotations during regular market hours that are within a certain percentage band of the national best bid and offer (NBBO).

May 6 Market Events

- The CFTC-SEC Joint Advisory Committee on Emerging Regulatory Issues released a report on February 18, 2011 that included14 recommendations in response to the May 6 Market Events. The recommendations included:
- The Committee concurs with the steps the SEC (working with the Exchanges and FINRA) has taken to: (a) Create single stock pauses/circuit breakers for the Russell 1000 stocks and actively traded ETFs; (b) Enact rules that provide greater certainty as to which trades will be broken when there are multi stock aberrant price movements; and (c) Implement minimum quoting requirements by primary and supplemental market makers that effectively eliminate the ability of market makers to employ "stub quotes."
- The Commissions require that the pause rules of the Exchanges and FINRA be expanded to cover all but the most inactively traded listed equity securities, ETFs, and options and single stock futures on those securities.
- The SEC work with the Exchanges and FINRA to implement a "limit up-limit down" process to supplement the existing pause rules.
- The CFTC and the relevant derivative exchanges evaluate whether a second tier of pre-trade risk safeguards with longer timeframes should be instituted when the "five second limit" does not attract contra-side liquidity.

May 6 Market Events

- The Commissions evaluate the present system-wide circuit breakers and consider: (a) reducing, at least, the initial trading halt to a period of time as short as ten minutes; (b) allowing the halt to be triggered as late as 3:30 pm; and (c) using the S&P 500 Index as the triggering mechanism.
- The SEC's "naked access" rulemaking and urges the SEC to work closely with FINRA and other Exchanges with examination responsibilities to develop effective testing of sponsoring broker-dealer risk management controls and supervisory procedures.
- The CFTC use its rulemaking authority to impose strict supervisory requirements on DCMs or FCMs that employ or sponsor firms implementing algorithmic order routing strategies and that the CFTC and the SEC carefully review the benefits and costs of directly restricting "disruptive trading activities "with respect to extremely large orders or strategies.
- The SEC evaluate the potential benefits which might be gained by changes in maker/taker pricing practices, including building in incentives for the Exchanges to provide for "peak load" pricing models.

May 6 Market Events

- The SEC evaluate whether incentives or regulations can be developed to encourage persons who engage in market making strategies to regularly provide buy and sell quotations that are "reasonably related to the market."
- The SEC and CFTC explore ways to fairly allocate the costs imposed by high levels of order cancellations, including perhaps requiring a uniform fee across all Exchange markets.
- The SEC conduct further analysis regarding the impact of a broker-dealer maintaining privileged execution access as a result of internalizing its customer's orders or through preferencing arrangements.
- The SEC study the costs and benefits of alternative routing requirements.
- The Commissions consider reporting requirements for measures of liquidity and market imbalance for large market venues.
- The SEC proceed with a sense of urgency, and a focus on meaningful cost/benefit analysis, to implement a consolidated audit trail for the US equity markets and that the CFTC similarly enhance its existing data collection regarding orders and executions.

F. Mutual Recognition

- Under Former SEC Chairman Chris Cox, the Commission sought various mutual recognition agreements with foreign regulators, including the European Union and Australia (August 2008).
- Current SEC Chairman Mary Schapiro has voiced concern over how fast the SEC proceeded over its mutual recognition arrangement with Australia. Expressing concern over the amount of investor protection in place, she has indicated (in press reports) that the SEC may "need to take a big step backwards and look at it again."

Mutual Recognition

- In some instances, our cooperation with our foreign counterparts takes place pursuant to a supervisory MOU. The SEC's comprehensive supervisory MOUs create mechanisms designed to ensure that the SEC and its counterparts will have access to the information necessary to oversee global firms, including broker-dealers, investment advisers, stock exchanges, clearing firms, and, more recently, hedge fund investment advisers, and entities that clear derivatives transactions. These MOUs also provide procedures for cooperation in on-site inspections and establish important confidentiality and other safeguards to ascertain the appropriateness of sharing non-public information in each circumstance.
- For example, the SEC has entered into comprehensive supervisory MOUs with the UK Financial Services Authority (March 2006), the German Bundesanstalt für Finanzdiestelesitunsaufsicht (BaFin) (April 2007), the Australian Securities and Investments Commission (August 2008), and, most recently, the Quebec Autorité des Marchés Financiers and the Ontario Securities Commission in Canada (June 2010). The SEC has also concluded more tailored arrangements with some of our counterparts, including an MOU with the College of Euronext Regulators relating to the oversight of NYSE Euronext (2007), and an MOU with the Hong Kong Securities and Futures Commission (1995) regarding investment advisor oversight. In addition, the SEC has a number of protocols with our European counterparts which provide for the sharing of issuer-specific information.
- SEC and Committee of European Securities Regulators (CESR) Members Announced Efforts to Continue Close Cooperation as National Securities Regulators Implement New Regulatory Reform Initiatives (November 18, 2010).

Mutual Recognition (Canada)

- **SEC MOU with Canadian Regulators:** On June 14, 2010, the Securities and Exchange Commission (SEC), Quebec Autorite des Marches Financiers (AMF) and Ontario Securities Commission (OSC) announced a comprehensive arrangement to facilitate the supervision of regulated entities that operate across the U.S. -Canada border. The Memorandum of Understanding (MOU), the first comprehensive supervisory MOU agreed to by the SEC since the start of the financial crisis, was signed by SEC Chairman Mary Schapiro, AMF President and CEO Jean St-Gelais, and OSC Chair David Wilson on June 10, 2010. It "provides a clear mechanism [beyond enforcement] for consultation, cooperation, and the exchange of information among the three agencies."

- The CFTC also signed a MOU with the Alberta Securities Commission, which took effect on June 10, 2010.

Mutual Recognition (Japan)

- **U.S.-Japan:** Securities and Exchange Commission Chairman Mary Schapiro and Japan Financial Services Agency (JFSA) Commissioner Katsunori Mikuniya met in Washington, D.C., as part of the annual SEC-JFSA Bilateral High-level Dialogue. The purpose of the Dialogue, established in 2006, is to provide a forum whereby the senior officials of the two agencies can meet to identify and discuss issues of common concern affecting the U.S. and Japanese capital markets and promote areas of future collaboration. (July 2, 2010)

- Chairman Schapiro and Commissioner Mikuniya reaffirmed their commitment to close cooperation between their agencies, particularly in the area of market supervision, to ensure market integrity in the increasingly interconnected global financial marketplace. The Dialogue also provided the opportunity for the SEC and the JFSA to discuss collaboration on the ongoing work on the multilateral front such as that currently underway in the International Organization for Securities Commissions (IOSCO).

Mutual Recognition (Future)

- **International:** "Developments in the international enforcement realm should serve as a template as we work to improve our information-sharing arrangements in the supervisory cooperation realm. Recently, in particular during the crisis, the IOSCO Multilateral Memorandum of Understanding (MMOU) has significantly aided regulators in combating cross-border fraud by allowing them to obtain information, including bank records, brokerage records, and testimony from overseas, needed to support their investigations. In many cases, IOSCO members have advocated for and won legislative changes at home that are needed to ensure their accession to the IOSCO MMOU. Through these efforts, local regulators have gained the authority necessary to provide assistance to their counterparts and to pursue securities law violations successfully in their own jurisdictions. Currently, more than 70 jurisdictions are signatories to the IOSCO MMOU and IOSCO has advised all its members to become signatories to the MMOU by 2013."—SEC Commissioner Walter speech (July 6, 2010).

- Noted IOSCO cooperation on credit rating agencies, broker-dealers, hedge funds, OTC derivatives, securities markets infrastructure, enforcement and supervision, and short selling.- SEC Commissioner Walter speech (July 6, 2010)

Mutual Recognition (Future)

- **Commissioner Casey (Senate Banking Testimony- July 20, 2010) –** "In addition to our collaborative efforts with our counterparts in IOSCO, the Commission is pushing ahead in developing much stronger and more extensive supervisory cooperation arrangements with a number of jurisdictions. These types of arrangements improve our abilities to share information at the operational level, to essentially "compare notes" with our counterparts abroad and share information about the entities we regulate. This combined emphasis – engagement with and strengthening of the international standard-setting bodies, and forging closer bilateral ties with our counterpart regulators overseas – is necessary for the high-level objectives of the G20 to be implemented in any meaningful fashion, and in ways that do not lead to regulatory arbitrage."

- **Commissioner Casey (Senate Banking Testimony- July 20, 2010)--**"I anticipate that there will be additional arrangements of this sort in the future. Certain provisions of the Dodd-Frank bill will facilitate supervisory cooperation between U.S. authorities and our foreign counterparts by further enabling and protecting information sharing with foreign authorities."

- **Still, SEC Chairman Schapiro** stated that it is unrealistic to have identical regulatory regimes. Rather, the goal is to have significant comparability among regimes, and many other regimes are well aware of this. She added that no country wants to be viewed as a "weak sister" in terms of regulation. (July 27, 2010- Comments—U.S. Chamber of Commerce Event on Implementing New Financial Regulations)

Mutual Recognition (Future)

- **CFTC Commissioner Scott O'Malia (7th Annual FIA Asia Derivatives Conference-November 30, 2011)** "The Commission has been in active dialogue with our Asian and European counterparts on proposed and final rules under the Dodd-Frank Act. The more jurisdictions can harmonize implementing legislation and regulations, the easier it will be for nations to institute mutual recognition. Mutual recognition, or some form of mutual accommodation, is essential to avoiding duplicative or contradictory regulatory obligations for participants in the OTC derivatives markets."
- **CFTC Chairman Gary Gensler (Testimony before the Senate Agriculture Committee-June 15, 2011)** "Some of the timing differences between U.S. and EU regulators will be eased by the proposed delay (in implementation of DFA provisions), as EU regulators are expected to move a legislative package containing derivatives trading and clearing rules in the fall. U.S. regulators are setting up work streams with their European counterparts to look at any differences in rules. The CFTC has a long history of mutual recognition agreements and is likely to sign approximately 15 to 20 mutual recognition agreements regarding derivatives."
- **Coalition of Trade Associations Commission Study on Mutual Recognition (January 2012)** It has been announced (in press reports) that a coalition of trade associations including the Futures & Options Association, SIFMA, AFME, ISDA, ABASA, Investment Industry Association of Canada, the Swiss Bankers Association, the Bankers Association for Finance and Trade, the Futures Industry Association and the ICMA, have commissioned a study on the viability of mutual recognition as a way of dealing with the problem of "third-country" requirements. Mutual Recognition was "enthusiastically" taken up by the SEC in 2006 but was tabled when the financial crisis hit in 2008. Ethiopis Tafara, head of international affairs at the SEC is heavily involved in the effort by U.S. and EU regulators to harmonize differences between the Dodd-Frank Act, EMIR, and MIFID.