The Regulatory Landscape- Recent Regulatory Actions and Proposals Affecting the Exchanges and Capital Markets and the Issues Raised

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Overview

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A. Market Structure Issues

- (1) Flash Orders, (2) Dark Pools, (3) High Frequency Trading/Co-Location, (4) Consolidated Audit Trail, (5) Large Trader Reporting, (6) Regulation SCI, (7) SEC Examines Market Technology, (8) Listed Options: Fees and Access, (9) Trade-At Rule, (10) Internalization, (11) Short Sales, (12) SRO Market Structure Filings, and (13) May 6 Market Events.
- 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, 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 is tasked "with developing recommendations regarding the definition of high frequency trading in the context of the larger universe of automated trading."
- In December 2012, former chief economist at the CFTC, Andrei Kirilenko, released an independent study in which he found that high-frequency traders make an average profit of as much as $5.05 each time they go up against small traders buying and selling one of the most widely used financial contracts. Kirilenko reported his findings at a Research Conference on Derivatives at the CFTC in November 2012. CFTC Commissioner Bart Chilton stated that the study shows that "high-frequency traders are really the new middleman in exchange trading, and they're taking some of the cream off the top."
- On October 30, 2012 the TAC subcommittee on HFT held a meeting in which the member discussed a proposed definition for HFT which includes high frequency trading as a form of automated trading that employs: (a) algorithms for decision making, order initiation, generation, routing, or execution, for each individual transaction without human direction; (b) low-latency technology that is designed to minimize response times, including proximity and co-location services; (c)high speed connections to markets for order entry; and (d) recurring high message rates (orders, quotes or cancellations) determined using one or more objective forms of measurement, including:(i) cancel-to-fill ratios; (ii) participant-to-market message ratios; or (iii) participant-to-market trade volume ratios.
- The Senate Permanent Subcommittee on Investigations (PSI) began investigating high frequency trading practices (even holding a hearing in December 2010 that included this subject). The Senate Banking Committee's Securities, Insurance, and Investment Subcommittee held hearings on market structure in Fall 2012, which have been more informational than investigative. Senator Jack Reed (D-RI), who chaired the Subcommittee, stated that a number of market disruptions, including the May 6, 2010 Flash Crash and the Knight Capital incident, raise questions about whether the rules in the market need to be changed. However, with the change in leadership on the Subcommittee, it is likely that the focus of this Subcommittee may change.

High Frequency Trading/Co-Location

- **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. In March 2013 it was announced (in press reports) that the SEC will team up with the FBI to investigate high frequency trading technology for potential market manipulation. (Source)
- **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.
- On July 18, 2012 the Financial Stability Oversight Council (FSOC) issued its annual report in which they voiced support for SEC/ CFTC "reigning in" HFT. The FSOC "recommends that the CFTC and SEC consider error control and risk-management standards for exchanges, clearing firms, and other market participants that are relevant for a high-speed trading environment . . . [and] continue to track developments in current and evolving market structure and analyze the need for policy responses when appropriate."
- In March 2013, CFTC Commissioner Bart Chilton, in a speech for the National Grain & Feed Association conference, stated that high-frequency trading firms conduct transactions with themselves in ways that distort liquidity in derivatives markets and warrant regulatory review. He stated that these so-called "wash sales," in which a party buys a contract from itself, are occurring even though they violate regulations set by the CFTC, CME Group (CME) Inc. and Intercontinental Exchange Inc.

Consolidated Audit Trail

- At a July 11, 2012 open meeting, the Securities and Exchange Commission (SEC) approved in a 3 to 2 vote a new rule requiring the national securities exchanges and self-regulatory organizations (SROs) to establish a market-wide consolidated audit trail (CAT). This rule was originally proposed on May 26, 2010. Then Chairman Mary Schapiro stated that a CAT will: improve the ability of regulators to reconstruct broad-based market events in an accurate and timely manner; increase the ability of regulators to monitor overall market structure; and reduce the regulatory data production burdens on SROs and broker-dealers by reducing the number and types of "ad-hoc" requests. Commissioner Elisse Walter "respectfully dissented" stating that the SEC should be guiding the SROs to leverage existing technology rather than adopting an "overly cautious" approach which falls short of what is needed to bring market oversight into the twenty-first century. Commissioner Luis Aguilar also dissented, noting concern that "the proposal fails to set appropriately specific requirements to ensure the creation of a comprehensive market surveillance system" that would include both the regulated and unregulated markets.
- According to the SEC staff release, the rule requires the exchanges and SROs to "jointly submit a comprehensive plan detailing how they would develop, implement, and maintain" such an audit trail. The CAT would "collect and accurately identify every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets." Certain data will be required to be reported to a "central repository" by 8 a.m. ET the following trading day. Reportable events are to be "tagged and stored by the central repository in a linked fashion" allowing regulators to more easily follow an order through its entire life cycle..." Each broker-dealer and national exchange will be assigned a unique identifier as will each customer and customer advisers with trading discretion. SROs and their members are required to synchronize their business clocks and reportable events must be time stamped in millisecond or finer increments. The SROs are given some flexibility in determining the specifics of how the data is reported to the repositories but must it be done in a way that the repository can then transmit to regulators in a uniform format. The SROs are required to provide details on how the CAT would be created, why reasonable alternatives were not chosen, detail estimated costs, discuss ways to eliminate unnecessary reporting, establish an Advisory Committee for the central repository, and provide information on anticipated error rates. The SROs will be required to submit their plan to the SEC within 270 days from publication of the rule. Once the plan is adopted, SROs will have one year to begin reporting to the central repository but small broker-dealers will have up to three years to begin reporting.

Consolidated Audit Trail

- The SEC had once estimated at the time of proposed rule that 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 had estimated that the average one-time initial cost per member could be approximately $1.5 million. The SEC further had estimated the costs for maintaining the consolidated audit trail system at $2 billion annually for the SROs and member firms.
- Note that from a "Market Data Solution" solicitation for an equity and equity option market data collection and analysis (November 2011), Tradeworx (Red Bank, N.J.) was awarded a contract in June 2012 to provide the SEC with a real-time data service to provide trading and quoting information. This is to better help the SEC to surveil and analyze markets.
- On February 19, 2013, SEC Chairman Elisse Walter gave a speech to discuss the technology the SEC is "bringing online" to help the SEC "leverage the talents and commitment of [SEC] staff to cover more ground and target [SEC] efforts far more precisely than would have been possible just a few years ago." Regarding the Consolidated Audit Trail (CAT), Walter expressed hope that the plan the self-regulatory organizations submit will ultimately produce a CAT that is "timely, accurate, complete and accessible and one that will provide for the eventual expansion to additional instruments, such as OTC equities, fixed income, and futures." She added that her "long-term vision is a consolidated audit trail that spans products, markets and the globe."
- On February 26, 2013 the SROs released a request for proposals (RFP) on how to build a consolidated audit trail for all market activity to comply with Securities Exchange Act Rule 613 (Rule 613), which was adopted by the Securities and Exchange Commission (SEC) in July 2012. The RFP sets the following milestones: March 5, 2013 intent to bid submissions; March 8, 2013, bidders conference; April 25, 2013, RFP responses due; April 26- June 2013, selection process; July 2013, preliminary section of bidder; December 2013, NMS plan filed; within two months of SEC approval, formal selection of bidder. On March 8, the industry working group developing the NMS plan projected that the CAT will most likely not be rolled out until sometime in 2017. (source)

Large Trader Reporting

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.
- The new rule has two primary components:
  - First, it requires large traders to register with the Commission through a new form, Form 13H.
  - Second, it imposes recordkeeping, reporting, and limited monitoring requirements on certain registered broker-dealers through whom large traders execute their transactions.
- On April 20, 2012, the SEC issued an order temporarily exempting broker-dealers from the recordkeeping, reporting, and monitoring requirements of the new rule 13h-1 and granting a permanent exemption for certain securities transactions. The SEC's order temporarily exempts registered broker-dealers from Rule 13h-1's recordkeeping and reporting requirements until May 1, 2013, except that clearing broker-dealers for a large trader that either (1) is a US registered broker-dealer, or (2) trades through a sponsored access arrangement, are temporarily exempted from the recordkeeping and reporting provisions until November 30, 2012.

Regulation SCI

- **Regulation SCI**: At a March 7, 2013 open meeting, the SEC voted unanimously (4-to-0) to propose a rule "Regulation Systems Compliance and Integrity (Regulation SCI)." Reg SCI "would require entities [known as 'SCI entities'] essential to the smooth functioning of the U.S. securities markets to have comprehensive policies and procedures regarding their technological systems." The rule is designed to assure that these systems: (1) "have adequate capacity, integrity, resiliency, availability, and security;" (2) "operate in the manner intended;" and (3) "are well-positioned to promptly take appropriate corrective action when problems arise." "SCI entities" under this proposal would include: (1) self-regulatory organizations (the registered national securities exchanges, registered clearing agencies, FINRA, and MSRB); (2) alternative trading systems "that exceed specified volume thresholds" (SCI ATSs); (3) "disseminators of market data under certain National Market Systems plans" ("plan processors"); and (4) "certain clearing agencies exempt from SEC regulation."

SEC Examines Market Technology

- **SEC Holds Market Technology Roundtable**: On October 2, 2012, the SEC held a roundtable entitled: "Technology and Trading: Promoting Stability in Today's Markets." The roundtable included panels on "the prevention of errors" and on "error response". Then SEC Chairman Mary Schapiro asserted that the stability of the securities market is tied to its own technological infrastructure. Schapiro stressed the need to address: (1) the structure of markets, "such as multiple execution venues, the presence of high frequency trading, dark pools, and the like"; and (2) the infrastructure of markets, "as in the technology that undergirds trading activity." Schapiro pointed out that a single infrastructure failure could have a ripple effect across the industry, and that limiting harm from technological errors "is not as good as preventing errors in the first place."

Listed Options: Fees and Access

- **Listed Options: Fees and Access**: On April 14, 2010, the 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 then 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."

Trade-At Rule

- **Trade-At Rule:** On February 18, 2011, the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues issued a report entitled Recommendations Regarding Regulatory Responses to the Market Events of May 6, 2010 setting forth its recommendations for regulatory action by the SEC and the CFTC in the wake of the so-called "flash crash" of May 6th.
- One recommendation involves adjusting the order routing system to a "trade-at" rule, which would require venues that do not display the national best bid-offer (NBBO) to present price improvement options or route the order to a venue that does display the NBBO. Revision of the order routing routine would involve significant investment in technology, and retail brokers would be required to display their order flow to other venues for possible price improvement instead of directly internalizing orders and retaining the revenue themselves.
- The Securities Industry and Financial Markets Association (SIFMA) submitted comments to the SEC in response to this proposal. While SIFMA supports the committee's efforts and improvements to existing initiatives and believes these programs are sufficient in addressing primary market structure issues raised by the Flash Crash events, they ultimately submitted a comment letter rejecting the proposals, noting that the committee's recommendations for more extensive changes to market structure — which includes the proposed trade-at rule — are unwarranted.
- On April 13, 2012, Canadian regulators passed new rules governing dark pools. The main goal of the rules, according to regulators, is similar to the U.S. concept of a "trade-at" rule. If a trade is to be executed in the dark, it must offer meaningful price improvement over the displayed market's price. The new rules will go into effect October 10, 2012.
- Note that both the NASDAQ and the NYSE have expressed support for a trade-at rule.
  - Duncan Niederauer, Chief Executive Officer, NYSE-Euronext testimony before the House Financial Services Committee on June 20, 2012: "NYSE believes that investors are more likely to have confidence in the securities markets if they believe that they are receiving fair prices when they buy and sell securities. As trading volume has shifted to new trading centers that operate with less transparency and fewer regulatory requirements, more and more information is outside of public view and excluded from the price discovery process. With incomplete public information concerning the full extent of market activity, combined with ever-increasing complexity regarding routing practices and sometimes limited transparency, it can be difficult to assess whether a customer is getting best order execution."
  - According to a Reuters article in February 2012 Nasdaq began lobbying Congress for an "amendment that would effectively set a partial "trade-at" rule by allowing newly-listed companies to require that any stock trades not conducted on an exchange be executed at a price that is "superior" to the best price displayed by any U.S. exchange.

Internalization

- **Internalization:** In December 2000, then SEC Chairman Levitt directed the Staff of the Office of Economic Analysis and the Office of Compliance Inspections and Examinations to prepare a report describing current payment for order flow and internalization practices, and outlining how the practices of payment for order flow and internalization have affected order routing decisions and the execution quality of customer options orders.
- The SEC issued a concept release in February 2004 seeking comment from market participants on various trading practices that are common in today's options markets. Among other things, the SEC has solicited the views of market participants on internalization of order flow. Internalization of order flow refers to the concept of a broker-dealer trading against its own customers' order flow. As a result, in February 2004, the SEC sought comment with respect to what action, if any, it should take with respect to internalization of order flow. After much consideration the SEC decided to not limit internalization.
- Recently there have been movements by the two largest exchanges, NYSE and Nasdaq, calling for a "trade at" rule which would limit internalization and "dark liquidity."
  - According to Duncan Niederauer, chief executive officer of NYSE Euronext, NYSE has lost share to what's called internalization, when brokers, which may operate dark pools, execute orders on their platforms at the best public price or better. NYSE has made recommendations to the SEC that they require dark pools and market makers that want to trade stocks without quoting publicly beforehand to improve the price the customer gets by a certain amount over what is available in the marketplace.
  - According to Thomas Joyce, Chairman and CEO of Knight Capital in testimony to the House Financial Services Subcommittee on Capital Markets on June 20, 2012, "Internalization is available for all investor types and access has been significantly democratized by the extremely networked lattice structure of venues. To move away from this networked venue system, with its lit and dark venues that offer more execution flexibility would be a step backward."

Short Sales

- **Short Sale Restrictions:** 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."
- **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. Note that the comment period for this report closed on June 23, 2011. Though it has not publicly done so far, the Commission is required to submit a report on the study to Congress by July 21, 2011.
- **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).
- On September 2, 2012, Canada's Investment Industry Regulatory Organization of Canada (IIROC) repealed the short sale tick test on Canadian stocks similar to what the SEC did in the U.S. in 2007.

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.

- On July 5, 2012, NYSE Euronext (NYX) received approval from the SEC to establish a Retail Liquidity Program, on a pilot basis. NYSE Euronext expects to activate the RLP on both the NYSE and NYSE MKT markets on Aug. 1, 2012. On January 17, 2013, NYSE filed a proposed rule change to allow Retail Member Organizations ("RMOs") to attest that "substantially all," rather than all, orders submitted to the Retail Liquidity Program qualify as "Retail Orders."

- **NASDAQ Retail Price Improvement Program:** On November 19, 2012, Nasdaq filed a proposal with the SEC for a Retail Price Improvement ("RPI") Program "to attract additional retail order flow to the Exchange while also providing the potential for price improvement to such order flow." As amended by a February 13, 2013 notice, Nasdaq proposed to clarify that, to qualify as a "Retail Order," a "riskless principal" order must satisfy the criteria for riskless principal orders set forth in a FINRA rule. The SEC, then in an order, approved Nasdaq's one year pilot program on February 15, 2013. On March 5, 2013, Nasdaq filed a rule change to allow a retail member organization to attest that "substantially all" orders submitted to the retail price improvement program will qualify as "retail orders".

- **NASDAQ Market Quality Program:** On December 7, 2012, NASDAQ filed with the SEC a proposed rule change to establish the Market Quality Program ("MQP"), a voluntary program designed to promote market quality in certain ETFs listed on the Nasdaq on a pilot basis. The SEC approved this pilot in March 2013.

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.
- The CFTC-SEC Joint Advisory Committee on Emerging Regulatory Issues released a report on February 18, 2011 that included 14 recommendations in response to the May 6 Market Events.
- On May 10, 2012 it was announced that the SEC and the CFTC intended to renew the Joint Advisory Committee for an additional two years.

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."
- 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

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

Limit Up–Limit Down

- On June 1, 2012, the Securities and Exchange Commission (SEC) announced that it approved two proposals submitted by the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) on a one year pilot basis that are "designed to address extraordinary volatility in individual securities and the broader U.S. stock market", such as what occurred during the May 6, 2010 "flash crash". The exchanges and FINRA will implement these initiatives, the limit up-limit down mechanism and updates to market-wide circuit breakers, by February 4, 2013.
  - The "limit up-limit down" mechanism is to prevent trades in individual exchange-listed stocks from occurring outside of a specified price band. This band "would be set at a percentage level above and below the average price of the security over the immediately preceding five-minute period" (ranging from 5% for liquid securities to 10% for other listed securities). In addition, the percentages "will be doubled during the opening and closing periods and broader price bands will apply to securities priced $3 per share or less." For certain price movements, "there would be a five-minute trading pause… if trading is unable to occur within the price band for more than 15 seconds."
  - The second initiative updates existing market-wide circuit breakers "that when triggered, halt trading in all exchange-listed securities throughout the U.S. markets." The changes "lower the percentage-decline threshold for triggering a market-wide trading halt and shorten the amount of time that trading is halted." The exchanges' plan would have market-wide circuit breakers begin on April 8, 2013.
  - On May 31, 2012 the SEC approved, on a pilot basis, a National Market System Plan, also known as Limit Up/Limit Down (LULD), to address extraordinary market volatility. Phase 1 of the plan will begin on April 8, 2013 and include all securities in the S&P 500, the Russell 1000 and select Exchange Trade Products (ETPs). Phase 1 is scheduled to be completed on May 31, 2013. Phase 2 (which includes the rest of the ETPs) will begin on August 1, 2013 and be completed by September 30, 2013. (source)

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).

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.

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."
- 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). Oral arguments were held in November 2012, but a decision in these cases (which have now been combined) were temporarily stayed.
- As a result, NetCoalition and SIFMA continue to challenge recent market data fee proposals by Nasdaq, NYSE, and other exchanges.

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 earlier this year.
- On November 12, 2012, Canadian Securities Regulators requested comment on the "Regulation of Market Data Fees".

C. Financial Regulation/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.
- According to the latest Dodd-Frank Act Progress Report from the firm DavisPolk (March 1, 2013), of the 398 total rulemaking requirements, 148 (37.2%) have been met with finalized rules and rules have been proposed that would meet 121 (30.4%) more. Rules have not yet been proposed to meet 129 (32.4%) rulemaking requirements.
- House Ways and Means /Senate Finance Committees in the current Congress have examined the taxation of financial products. This has the potential to raise ire in the financial community though at this point, there is a low likelihood of this advancing beyond the House.

Financial Regulation (General)

- Created a Financial Stability Oversight Council (FSOC) to identify and regulate financial firms that are large, interconnected, or systemically risky. (Note that the constitutionality of this regulatory council is currently being challenged in the DC Circuit-State National Bank of Big Spring, et al. v. Geithner, et al.)
- 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, there is to be a reduction in 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. (Note that the constitutionality of the CFPB is currently being challenged in the DC Circuit-State National Bank of Big Spring, et al. v. Geithner, et al.)- The constitutionality of the CFPB is further being challenged because of the recess appointment made by President Obama of Richard Cordray to be Director of the CFPB. This recess appointment further comes into question following the decision in Noel Canning v. National Labor Relations Board, 12-1115, 12-1153, U.S. Court of Appeals for the District of Columbia (Washington), on January 25, 2013. In the ruling the DC Court of Appeals struck down President Obama's "recess appointments" of three National Labor Relations Board members as unconstitutional.

Financial Regulation: SEC

- On January 22, 2011, the SEC submitted to Congress a staff study recommending a uniform fiduciary standard of conduct for broker-dealers and investment advisers -- no less stringent than currently applied to investment advisers under the Advisers Act -- when those financial professionals provide personalized investment advice about securities to retail investors. Creates a program within the SEC to encourage people to report securities violations. Note that there was legislation in the House ("Investment Adviser Oversight Act of 2012" (H.R. 4624)), that would seek to form a SRO that would oversee investment advisers and broker-dealers.
- 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)
- Creates the Investment Advisory Committee, a committee of investors to advise the SEC on its regulatory priorities and practices; the Office of Investor Advocate in the SEC, to identify areas where investors have significant problems dealing with the SEC and provide them assistance; and an ombudsman to handle investor complaints.
- Creates a program within the SEC to encourage people to report securities violations.
- 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.
- On March 1, 2013, the SEC requested data and other information on a uniform fiduciary standard of conduct, and also requested comments on proposed concepts for a uniform standard for broker-dealers and investment advisers. The Request Release also asks for data concerning the effect of rule harmonization between the broker-dealer and investment adviser regulatory schemes.

Financial Regulation: SEC

- **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.
- **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). The primary recommendation of the study is to enable investors to simultaneously search both databases using either FINRA's BrokerCheck website or the Investment Adviser Public Disclosure (IAPD) website and receive unified search results. In May 2012 FINRA announced that it had added features to BrokerCheck to help users more easily access broker-dealer and investment adviser registration information addressing the recommendations made in the 2011 study.(source)
- **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).

Financial Regulation: Hedge Funds

- Title IV of the Dodd-Frank Act makes numerous changes to the registration and reporting and recordkeeping requirements of the Investment Advisers Act of 1940. Among these is the requirement that advisers to most private funds (hedge funds and private equity funds) register with the Commission. Only advisers that advise exclusively venture capital funds and advisers solely to private fund with less than $150 million in assets under management in the United States are exempted. Foreign private advisers and advisers to licensed small business investment companies also are exempted.
- The Dodd-Frank Act provides the Commission with the authority to collect data from registered investment advisers about their private funds for the purposes of the assessment of systemic risk by the Financial Stability Oversight Council. In addition, the Dodd-Frank Act modifies the allocation of responsibility for mid-sized advisers between state regulators and the Commission.
- These amendments under the Dodd-Frank Act took effect on July 21, 2011 (one year from the date of enactment of the Dodd-Frank Act). On June 22, 2011, the Commission adopted definitional rules and implementing rules, including transitional rules, to implement the Dodd-Frank Act amendments. The definitional and transitional rules became effective on July 21, 2011. The implementing rules generally became effective on September 19, 2011.
- On October 31, 2011, the SEC adopted rules (jointly with the CFTC for dually-registered advisers) requiring advisers to hedge funds and other private funds to report information for use in monitoring systemic financial risk.

Financial Regulation: Revisited

- **SEC Cost-Benefit Analysis:** On March 12, 2013, Representative Scott Garrett (R-NJ) introduced H.R. 1062 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. In the 112th Congress, the House Financial Services Committee favorably reported an earlier version of this bill.

- **Financial Regulator Cost-Benefit Analysis:** Senator Richard Shelby (R-AL), introduced S.450 the "Financial Regulatory Responsibility Act of 2013" (substantially similar to a bill introduced in the last Congress S. 1615) on March 5, 2013, 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. Note that an amendment to Senate Budget offered by Senator Shelby related to this bill was not approved on March 23, 2013. On March 5, 2013, Senator Shelby also introduced the "Dodd-Frank Wall Street Reform and Consumer Protection Technical Corrections Act of 2013" (S. 451) which makes technical corrections to portions of the Dodd-Frank Act.

Financial Reform: SEC Cost/Benefit Analysis

- On March 16, 2012, the SEC's Chief Economist and General Counsel released new guidance for conducting economic analysis.
- Specific steps included in the current staff guidance, are:
  - earlier and more comprehensive involvement of RSFI staff in the rulemaking process;
  - assuring that rule releases clearly identify the justification for the proposed rule;
  - where a statute directs rulemaking, staff should consider the overall economic impacts of the rule, including those attributable to Congressional mandates and those resulting from the Commission's exercise of discretion;
  - where feasible, quantifying the costs and benefits and, where not reasonable to do so, transparently explaining why not, and then qualitatively explaining the remaining costs and benefits;
  - more integrated analysis of economic issues (including efficiency, competition, and capital formation) in the Commission's rule releases;
  - more explicit encouragement to commenters to provide quantitative, verifiable estimates of costs and benefits, and fuller analysis and discussion in Commission rule releases of the cost-benefit information received from commenters; and
  - greater discussion of reasonable alternatives not chosen.
- The new guidance also provides more specific ways to strengthen what the SEC recognizes as the essential components of sound regulatory economic analysis: clearly identifying the justification for the proposed rule; defining the baseline against which to measure the proposed rule's economic impact; identifying and discussing reasonable alternatives to the proposed rule; and analyzing the economic consequences of the proposed rule and the principal regulatory alternatives.

Financial Reform: SRO Rule Filing

- **Streamlining of Filing Procedures:** Within 45 days from the publication of an SRO proposed rule, the SEC is to approve such rule or institute proceedings to determine whether it should be disapproved. The SEC may still delay its decision for up to 45 days if it determines that a longer period is appropriate (as long as it publishes its reasons) or if the SRO consents. However, if the SEC does not approve the proposed rule change, it shall provide for a notice and hearing within 180 days of publication. The SEC is to issue an order approving or disapproving the proposal (and may still extend this for up to 60 days if it is appropriate or if the SRO consents) within this 180-day period. (Section 916)

- **Standards for Approval and Disapproval:** The SEC shall approve an SRO proposal if it finds that it is consistent with this legislation within 30 days (unless there is good cause for an earlier approval) or conversely, the SEC is to disapprove it if it is not consistent. Should the Commission not begin proceedings within 45 days or issue an approval or disapproval order within 180 days (with an extension of 60 days), the proposed rule will have been deemed approved. (Section 916)

- **Approval/Disapproval Rulemaking:** Not later than 180 days after the date of enactment of the financial reform legislation, the SEC shall issue rules implementing an approval/disapproval process. (Section 916)

- **Conclusion:** The Dodd-Frank Act's imposition of new procedural requirements has increased the volume of annual requests "by over 80 percent in the last five years." Then SEC Chairman Schapiro (April 25, 2012 House Financial Services testimony) has stated that she hoped the SEC to be in a position "to dedicate additional resources to these approvals" to reduce uncertainty.

Financial Reform: SROs

- **SEC Commissioner Gallagher Discusses Equity Market Structure and Role of Self-Regulatory Organizations** --On October 4, 2012, the Securities and Exchange Commission (SEC) Commissioner Daniel Gallagher provided remarks on: "Time for a Fresh Look at Equity Market Structure and Self-Regulation". Noting the many changes in the markets and regulation over the years, he called on the SEC to "pursue a new comprehensive study that addresses both market structure and self-regulation" and suggested that this "means revisiting the 1975 Act amendments, and [would] most likely result in recommendations to Congress to amend existing legislation to reflect the realities of today's markets."
- In addition to the possible need for legislation, Gallagher suggested that there are some "fundamental market structure and self-regulation questions" that should be asked, including the following topics:
- **SRO Structures/Status:** Gallagher questioned the relevancy of the current regulatory structure "in a world of demutualized, public company exchange operators" and whether exchanges should still be self-regulatory organizations (SROs). He also queried whether ownership restrictions should be imposed on exchanges and whether non-SRO exchanges "continue to enjoy prosecutorial immunity based on their historical quasi-governmental status."
- **Market Data:** Given the historical role of market data fees in funding SROs, Gallagher questioned what should be done "with the market data fees in a world in which exchanges aren't SROs."
- **SRO Rule Filing:** Gallagher questioned whether the amendments to section 19(b) of the Securities Exchange Act (as amended by section 916 of Dodd-Frank Act), relating to SRO rule filing procedures, "merely replaced one problematic regime with another."

Financial Reform: SROs

- **Role of FINRA:** Gallagher posited that there may be a need to ask questions about the role of FINRA, and whether it is becoming a "deputy SEC". He questioned whether FINRA should "be seeking to branch out into entirely new fields of responsibility, such as regulating investment advisers." He also questioned whether allowing exchanges to outsource the bulk of their regulatory responsibilities to FINRA through regulatory services agreements risks implicitly transforming the meaning of SRO to "selectively regulatory organizations";
- **SRO Cost-Benefit Analysis:** Another question raised by Gallagher is whether the SROs have the resources and the willingness "to perform sufficiently rigorous analyses to support their rulemaking." He claimed that "[i]f self-regulation is to continue to play a central role in securities regulation, SROs must be committed to ensuring that the rules they send to the Commission for approval are the result of the same degree of rigorous analysis as the Commission applies to its own rules."

Financial Reform: SEC Funding

- **SEC Funding:** The SEC is to collect transaction fees and assessments that are designed to recover the costs to the Government of the annual appropriation to the SEC by Congress. The SEC is to adjust, by order, the fee rates for a fiscal year to a uniform adjusted rate that is reasonably likely to produce aggregate fee collections that are equal to the regular appropriation to the SEC by Congress for such fiscal year. The SEC may adjust this rate, as needed, by March 1st of such fiscal year. This takes effect on the later of October 1, 2011 or the Date of Enactment making a regular appropriation to the SEC for fiscal year 2012. A separate fund, known as the "Securities and Exchange Commission Reserve Fund" is established in the U.S. Treasury, where the SEC is to deposit any registration fees collected, but not in excess of $50 million for any one fiscal year. The balance of the account shall not exceed $100 million. Any excess amounts are deposited in the General Fund of the Treasury and are not available for obligation by the SEC. The Reserve Fund is to be effective on October 1, 2011. (Section 991)

The Dodd-Frank Act authorizes appropriations to the SEC as follows:

- Fiscal year 2012: $1.5 billion
- Fiscal year 2013: $1.75 billion
- Fiscal year 2014: $2.0 billion
- Fiscal year 2015: $2.25 billion

But the SEC was actually appropriated:

- Fiscal year 2012: $1.321 billion
- Fiscal year 2013: $ 1.321 billion. However by October 2013, the SEC is required under sequestration to cut its budget by an additional 5% ($66 million) to about $1.255 billion. The recently approved continuing resolution (which required further cuts to many government agencies) appears to not have required further budgetary cuts for the SEC.

Financial Reform: SEC Funding

A few key takeaways of the SEC funding provisions in the Dodd-Frank Act:

- Section 31 fees will be dedicated solely to paying for the entire regular budget of the SEC (the amount appropriated to the SEC by Congress).
- Authorized funding for the SEC significantly increases to $2.25 billion by fiscal year 2015, up from the current $1.1 billion.
- The new SEC funding process in the Dodd-Frank Act provides little incentive for legislators to keep SEC funding low since all funding would be recovered by Section 31 fees collected from the industry and no excess Section 31 fee collections could be used by appropriators.
- If Congress appropriates to the SEC an amount comparable to the authorized funding included in the Dodd-Frank Act, Section 31 fees are likely to increase substantially.

D. Jumpstart Our Businesses Startups (JOBS) Act

- Signed into law on April 5, 2012.
- Title I ("IPO On-Ramp"), and Titles V and VI (Increased registration/reporting triggers under the Securities Exchange Act of 1934 for non-bank issuers and bank holding companies; easier exit for bank holding companies) are effective immediately.
- Some SEC rulemaking is required on Title II (Lift ban on general solicitation/advertising in Rule 506 and 144A) due 90 days from enactment (July 4, 2012), Title III (Crowdfunding) due 270 days from enactment, and Title IV (Regulation A+) no deadline. None of these deadlines have been met.
- Prior to the adoption of the JOBS Act, the SEC in 2011 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.
- JOBS Act Section 504 Report to Congress: On October 16, 2012, the SEC staff released a study on JOBS Act Section 504 that concluded that the current enforcement tools available to the SEC are adequate to enforce the anti-evasion provision of Rule 12g5-1 (which requires an issuer of a certain size to register with the SEC and file periodic and current reports).
- Despite statements from SEC Chairman Elisse Walter this year that completing the remaining rulemakings and other projects mandated by the JOBS Act "will be at the top of the list" of agenda items, the rules have not been completed yet. SEC Nominee Mary Jo White made similar statements at her confirmation hearing before the Senate Banking Committee. White stated that she has "no higher priority" then moving on the Dodd-Frank Act (DFA) and JOBS Act rulemakings as soon as possible. She claimed that the SEC can do those rulemakings "well and smart" yet get them out quickly. She stated that she has no specific date but will be focused on that from day one.
- Overall, with the inability of the SEC to move forward with JOBS Act rulemakings, Congress, notably House and Senate Republicans have looked to move forward on JOBS Act II measure that could address the shortcoming of the JOBS Act.

JOBS Act : Title I (Emerging Growth Companies)

- Streamlines the IPO process and relaxes post-IPO requirements for a new category of issuer- the "emerging growth company." (EGC)
  - EGC has less than $1 billion in total annual gross revenues
  - EGC will remain so until the earliest of: last day of the fiscal year during which it had total gross revenues less than $1 billion, the last day of the fiscal year following the fifth anniversary of its IPO, date on which it has over a rolling three year period issued less than $1 billion in non-convertible debt securities, or date on which it is deemed to be a large accelerated filer.
  - Reduces the level of IPO registration statement disclosure
  - Allows for "confidential submissions"
  - Allows for "testing the water" communications with qualified institutional investors (QIBs) or institutional accredited investors (IAIs).

  - The SEC has issued FAQs on General Applicability of Title I (September 28, 2012), Draft Registration Statements Required to Be Submitted and Filed Using EDGAR (October 11, 2012), Draft Registration Statements to Be Submitted and Filed on EDGAR (September 26, 2012), Research Analysts and Underwriters (August 22, 2012), FAQ: Confidential Submission Process for Emerging Growth Companies (April 10, 2012).

JOBS Act : Title II (General Solicitation/ General Advertising)

- SEC within 90 days must amend existing prohibitions against "general solicitation" or "general advertising"
- The SEC is to eliminate the ban on general solicitation and advertising in connection with certain private offerings provided that all purchasers are accredited and the issuer took reasonable steps to verify this fact. (Rule 506 of Regulation D)
- The SEC is to revise rules to provide that securities sold under the revised exemption may be offered to persons other than QIB, by means of general solicitation or general advertising provided certain conditions are met. (Rule 144A)
- At an August 29, 2012 open meeting, the Securities and Exchange Commission (SEC), in a 4-to-1 vote, proposed a rule to eliminate the prohibition against general solicitation and general advertising in certain securities offerings. This rule proposal was subject to a 30 day comment period.
- In sum, under the proposed rules companies issuing securities would be permitted to use general solicitation and general advertising to offer securities provided that the issuer takes reasonable steps to verify that the purchasers of the securities are "accredited investors." Also under the proposed rule, securities sold in this manner could be offered to persons other than "qualified institutional investors" (QIBs), including by means of general solicitation, provided that the securities are sold only to persons whom the seller reasonably believes is a QIB.
- The SEC on February 5, 2013 issued an FAQ on "the Exemption from Broker-Dealer Registration in Title II of the JOBS Act."
- The SEC has not met its July 4, 2012 deadline in finalizing this provision nor even its goal (according to the SEC's most recent semi-annual regulatory agenda) to finalize such rules by December 2012.

JOBS Act : Title III (Crowdfunding)

- Exempts offerings designed to harness the power of the "crowd" and mass social communication from 1933 Act registration requirements and state blue-sky laws.
- Under "crowdfunding", non-reporting issuers are permitted to raise up to $1 million in reliance on the exemption within any 12 month period, with a maximum investment per investor of: the greater of $2,000 or 5 percent of the investor's annual income or net worth within any 12 month period; and 10 percent of the investor's annual income or net worth, not to exceed a maximum amount of $100,000.
- In addition, the transaction would need to be conducted through an SEC-registered broker or "funding portal". A funding portal is defined as a crowdfunding intermediary that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or others persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in such other activities as the SEC, by rule, determines appropriate.
- Lastly, the issuer is to file with the SEC and provide to investors and the intermediary information on itself.
- SEC staff has conducted industry outreach and claims that "ironing out" investor protections will take some time. On May 7, 2012, the SEC released FAQs on crowdfunding intermediaries and on April 23, 2012 issued a release reminding market participants that until rules are implemented "any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws." The Financial Industry Regulatory Authority (FINRA) filed with the SEC a proposed rule change regarding an "Interim Form for Funding Portals" (IFFP), which is "an online form for prospective intermediaries that intend to apply for membership with FINRA as funding portals".
- SEC had 270 days to issue rules (by January 2013), but has not met its deadline to finalize this provision nor even its goal (according to the SEC's most recent semi-annual regulatory agenda) to propose such rules by December 2012.

JOBS Act : Titles IV, V and VI
Increased Threshold for SEC Registration

- Create a new exemption from registration with an increased offering amount and additional conditions (Regulation A). First, it raises the cap in the exemption for small public issuances of unrestricted debt, equity, or convertible securities to $50 million from $5 million in any 12 month period. These issuers are to file and distribute to prospective investors an offering statement containing specified disclosures. Lastly, the SEC is to review and increase biennially such offering amount limitation as appropriate; and report to certain congressional committee on its reasons for not increasing the amount.
- Overall, the JOBS Act raises the current 500-shareholder threshold for registration with the SEC to 2,000 shareholders so long as not more than 499 shareholders are not accredited investors.
- On February 15, 2013, Representative Patrick McHenry (R-NC) introduced H.R. 701, legislation providing the SEC with an October 31, 2013 deadline to finalize Regulation A rules.
- July 2012 GAO study of the impact of state securities laws ("Blue Sky Laws") on public offerings by private companies under Regulation A found that "even with the increased attractiveness of the $50 million ceiling, blue sky requirements may still dampen small business‟ interest in Regulation A."
- JOBS Act Section 504 Report to Congress: On October 16, 2012, the SEC staff released a study on JOBS Act Section 504 that concluded that the current enforcement tools available to the SEC are adequate to enforce the anti-evasion provision of Rule 12g5-1 (which requires an issuer of a certain size to register under the Exchange Act and file periodic and current reports).
- SEC issues FAQ dealing with issues of registration for equity securities and the deregistration or suspension of reporting requirements for bank holding companies (April 11, 2012).

JOBS Act

- Comments from Industry on JOBS Act Implementation from a June 20, 2012 House Financial Services Committee's Subcommittee on Capital Markets and Government Sponsored Enterprises hearing on "Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors."
  - Tom Joyce (Knight Capital Group)- Knight fully supports the proposal to widen spreads for certain tiers of securities, including higher priced stocks, less liquid stocks, etc. In a one-penny spread environment it is very often difficult to aggregate meaningful volume at the one-penny increments for certain securities. Knight fully support the "tick-size" study offered by Representative David Schweikert that was included in Title I, Section 106(b) of the JOBS Act.
  - William O'Brien (Direct Edge)- The legislative proposal put forth by Representative McHenry would be an important first step in making exchange markets a more hospitable place for small public companies. The proposal, which would allow exchanges to create and administer incentives to ensure the provision of liquidity for their stocks, would give companies more meaningful choices.
  - Jim Toes (Security Traders Association)- Regulations should be reviewed to remove disincentives to the commitment of capital by trading operations with market making, both electronic and traditional, and block trading. STA is encouraged that the Jumpstart Our Business Startups (JOBS) Act included a requirement for the SEC to examine the impact decimalization has had on IPOs and on liquidity for small and mid- cap company securities. STA recommends an examination of the impact of decimalization on electronic and traditional market making, as well as on other liquidity providers, considering: the costs of maintaining a trading operation in a decimalization regime; and the balance of market maker obligations with the benefits they may receive from that status.

JOBS Act: Miscellaneous

- On April 11, 2012 the SEC issued a notice requesting comment on the provisions listed under the JOBS Act, including the study to review minimum tick size (Representative Schweikert (R-AZ) Amendment) and possible changes to the trading increment. On July 20, 2012, the SEC released its staff report on decimalization, which recommended that the SEC "not proceed with the specific rulemaking to increase tick sizes… but should consider additional steps that may be needed to determine whether rulemaking should be undertaken in the future." The SEC then had 180 days to increase the trading increment for emerging growth companies, but did not act within that time period.
- On May 18, 2012, Facebook the leading social networking site, launched its IPO. The IPO was plagued by a series of issues such as its listing exchange Nasdaq suffering from computer malfunctions during the first hours of the IPO which led to tens of millions of dollars in trades being wrongly placed; JP Morgan who was underwriting the IPO is being accused of placing the initial share price too high with too many share available; and Facebook executives are accused of alerting industry insiders to Facebook's earnings before they were made public. More than a dozen lawsuits by shareholders have accused Facebook and its underwriters of hiding the company's weakened growth forecasts ahead of the May 18 IPO. The SEC is probing the role of Nasdaq, which suffered a technical breakdown that delayed trading for 30 minutes. The SEC recently approved a compensation plan settlement offered by Nasdaq, though not all are content with this offer. (Source)
- On July 17, 2012, Congressman Patrick McHenry (R-NC) introduced the Liquidity Enhancement for Small Public Companies Act, (H.R. 6127). The legislation would allow stock exchanges to develop incentive programs for market makers to support small company stocks. Commonly referred to as Market Quality Incentive Programs, the option is already available to small-capitalization stocks on European exchanges.
- On February 5, 2013, the SEC held a roundtable on decimalization (in conjunction with this JOBS Act report) to discuss "how to best study its effects on IPOs, trading, and liquidity for small and middle capitalization companies, and what, if any, changes should be considered." Chairman Elisse Walter stated that she is interested in a discussion of a possible pilot program and how such a pilot might be formed. Some participants at the roundtable expressed differing views on whether a pilot program for tick sizes would be helpful to investors and for the provision of research coverage for smaller capitalization companies.
- SEC Division of Trading and Markets Acting Director John Ramsay suggested in recent press reports that the SEC was looking at how a pilot program (of varying tick sizes) could be structured, noting that there seems to be a lot of support for such a pilot. (Source).
- At a March 12, 2013 Senate Banking Nomination hearing, SEC Nominee Mary Jo White stated that she has to examine a potential pilot program for increased tick sizes before she can draw a conclusion. But she stated that it will be a priority to focus on this issue and suggested that "one size does not fit all."

E. Mutual Recognition

- 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 its 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).
- According to press reports, Industry Trade Groups (ISDA, LME, FIA) petitioned International Organization of Securities Commissions (IOSCO) to become responsible for mutual regulatory recognition among countries and regions. (March 2013).

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. 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:** Then SEC 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)
- Then 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).
- On June 27, 2012, at a keynote speech at the International Derivatives Expo held in London David Wright, secretary general at the International Organisation of Securities Commissions (IOSCO), issued a "rallying call" for greater global cooperation on financial standards, to help investors trade anywhere in the world with greater confidence.
- In November 2012, leaders of authorities with responsibility for the regulation of the over-the-counter (OTC) derivatives markets in Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the United States released a joint statement. These leaders expressed interest in regulatory approaches that included voluntary regulatory deference. In their statement, this diverse group of regulators agreed that some form of limited regulatory "recognition," acceptance of "substituted compliance," or specific "exemptions" "should be considered" in crafting regulatory regimes applicable to OTC derivatives, given the "need to prevent the application of conflicting rules and the desire to minimize … the application of inconsistent and duplicative rules."
- With the recent issues with LIBOR manipulation, CFTC Chairman Gary Gensler cited the need for a new financial market benchmark and has been working within the IOSCO structure to undertake this. He stated earlier this year that "[g]iven what we know now, it's critical that we move to a more robust framework for financial market benchmarks, particularly those for short-term variable interest rates."

Mutual Recognition (Future)

- **CFTC Chairman Gary Gensler at the 2012 FINRA Annual Conference- May 21, 2012:** "The role the swaps market played in the 2008 crisis led to a new international consensus that the time had come for comprehensive regulation. . . Among the important remaining matters, the Commission is working with fellow regulators here and abroad on an appropriate and balanced approach to the cross-border application of Dodd-Frank swaps market reforms."
- **SEC Chairman Elisse Walter (Speech to American Bar Association International Section-October 2, 2012):** "The Commission cannot take actions in areas merely for the sake of international consistency if it is not the right thing to do for U.S. investors and U.S. markets. But I believe that more often than not, what is in the best interest of the U.S. markets and what is in the best interest of the global market will not be mutually exclusive." She noted that the SEC was working with its international counterparts on derivatives and accounting rule as well as implementing a unified legal entity identifier system.
- **SEC Chairman Elisse Walter (remarks to Australian Securities and Investments Commission (ASIC) Forum ---March 24, 2013):** On the challenges facing financial regulators, she focused on "the need to encourage consistent regulation for securities markets across borders, and the degree to which international regulatory policy is part of the core mission [of] market regulators." Walter called for cross-border regulation coupled with "substituted compliance" in the OTC derivatives market and for international financial market regulators (such as the SEC) to offer their experience on broker-dealer regulation to reduce systemic risk and avoid a one-size fits all approach in the applicability of global standards to banks and non-banks.

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)** "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.