Securities Regulation Daily Wrap Up, TOP STORY—Second Senate panel eyes high frequency trading role in market structure reform, (Jun. 18, 2014)

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For the second day in a row, a Senate panel hearing on high frequency trading revealed both concern and support for the SEC's overall review of market structure. Senator Mark Warner (D-Vir.), chair of the Securities Subcommittee of the Senate Banking Committee, specifically urged the SEC to expedite implementation of the consolidated audit trail. Both Senator Warner and the Committee's Ranking Member, Senator Mike Johanns (R-Neb.) expressed support for a tick size pilot program, with Senator Johanns mentioning that legislation directing the SEC to conduct such a program passed the House by a vote of 412-4.

Senator Johanns noted that market structure issues must be addressed with the ultimate goals being fairness, liquidity, and transparency. He expressed confidence in SEC Chair Mary Jo White, strongly endorsing White's recent statement that the SEC should not roll back the technology clock or prohibit algorithmic trading, but is assessing the extent to which specific elements of the computer-driven trading environment may be working against investors rather than for them.

Harvard Law Professor Hal Scott, chair of the Committee on Capital Markets Regulation, was concerned is that the recent frenzy over high frequency trading will draw attention away from other important market structure issues. For example, as co-chair of the Equity Capital Formation Task Force, along with his fellow panelist Jeffrey Solomon, Mr. Scott has been highly supportive of a tick-size pilot program for small cap stocks and is encouraged by the SEC's recent commitment to conduct such a program.

While the U.S. equity market is not "broken," he said that there is always room for improvement so long as they are targeted improvements of the current regulatory structure, including with respect to certain practices of high frequency traders. He noted that the SEC staff is working to develop a recommendation for an anti-disruptive trading rule. While in theory such a rule has potential as a targeted solution aimed at aggressive short-term traders, the devil is in the details. The rule would be aimed at active proprietary traders during specific, short time periods when the markets are most vulnerable. Basic questions will need to be addressed, such as which traders should be restricted, during which time periods, and for which activities.

Chair White has also asked the staff to propose a recommendation that would subject unregistered active proprietary traders to the SEC's rule as dealers. While the rule could potentially be an effective tool in monitoring and regulating the behavior of harmful trading practices, he noted, it may be difficult to identify which "unregistered active proprietary traders" should be subject to broker-dealer requirements. Similar difficulties were seen in the new practice of designating "swap dealers" under Dodd Frank. Furthermore, a number of these entities may be subject to oversight already. The SEC should ensure that any registration requirements are streamlined and coordinated.

In his testimony, Mr. Solomon, CEO of Cowen and Company, said that the challenges surrounding high frequency trading are actually a symptom of a more complex market structure that promotes and encourages potentially counterproductive trading behavior --behavior that reduces the availability of capital for smaller capitalization companies to expand their businesses and reduces liquidity for investors. As such, any debate about the pros and cons of high frequency trading really needs to address the structure of the equity market that has given rise to its existence. He encouraged lawmakers and regulators to explore and implement modifications to the current market structure to further improve equity market function.

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