Remarks at the Equity Market Structure Symposium Sponsored by the University of Chicago and the STA Foundation

Chairman Jay Clayton

Chicago

April 10, 2018

Thank you for such a kind introduction. And thank you as well to the University of Chicago and the STA Foundation for the invitation to speak today about equity market structure.

In my first remarks last year as SEC Chairman, I identified market structure as an area where we should focus a meaningful portion of our limited Trading and Markets resources. In this vein, last November the Commission established the Fixed Income Market Structure Advisory Committee. We also remain focused on equity market structure, and I am pleased to use this forum to discuss my views on equity market structure in greater detail.

One of the few certainties of trading markets is that they continually evolve. New technologies spur new market mechanisms, which, in turn, lead to new trading practices. And regulations affect that evolution. In short, the granular effects of technological developments – think trade types, for example – reflect the regulatory framework. And, the sum of those granular effects can have a significant impact on market function, and therefore, market efficiency, integrity and resilience. One of our key responsibilities as regulators is to strive to ensure that, as technology changes, our regulations continue to drive efficiency, integrity and resilience.

Principled Approach to Equity Market Structure

So with that perspective on the effects of regulation, I want to take a step back and discuss a few principles. In a prior speech I outlined eight principles that would guide my tenure. Five of those are particularly relevant when considering equity market structure.

The first principle is fidelity to the SEC's three-part mission: (1) to protect investors, (2) to maintain fair, orderly, and efficient markets, and (3) to facilitate capital formation. Equity market structure is integrally related to each of these three tenets. Fair, orderly, and efficient markets protect investors. Attracting a broad range of investors provides the liquidity that promotes efficient markets. And vibrant equity markets underpin capital formation in many ways, including by facilitating the raising of equity capital by public companies and by providing valuable information – think price discovery through comparable metrics – about a company's value.

Another basic principle is remaining focused on the long-term interests of our Main Street investors. And, by this, I mean a true understanding of how Main Street investors participate in today's equity markets. They do so through direct investments in stocks, of course, but also, and just as importantly, they invest indirectly by relying on the efforts of intermediaries such as mutual funds, pension funds, and exchange-traded funds. A quality market structure must advance the interests of Main Street investors in each of these varying contexts.

A third guiding principle is facilitating transparency. Regulations that promote public access to material information can empower investors and also can energize the competitive forces that benefit investors. In this way, transparency can substantially reduce the need for overly specific and prescriptive restrictions on conduct that can impede competitive forces and, in an evolving, complex system, can become outdated, ineffective and counterproductive.

The next principle, retrospective review, follows logically from this point. We should listen to investors and market participants about where Commission rules are, or are not, functioning as intended. Although those views are diverse and not necessarily consistent, all constituencies should not be shy in advocating for improvements in our approach to equity market structure. Actual experience is essential to effective retrospective review.

Finally, meaningfully assessing regulatory initiatives requires both coordination with other regulators and open communication with the various stakeholders in the markets that we oversee. To do our job properly and effectively at the SEC, we must engage with, listen to, and learn from investors and a broad array of industry participants. In particular, I recognize that we must take a holistic approach to market structure that recognizes the interrelationships among regulations, products and behavior. I expect coordination and communication will be an integral part of my future plans for equity market structure.

Top Focus Areas for Enhancing Equity Market Structure

Fortunately, we need not work from a blank slate in identifying the most pressing equity market structure questions. The EMSAC, for example, tackled a broad spectrum of market structure topics and made a number of thoughtful recommendations to the Commission.[1] And last October, the Department of the Treasury published an insightful report that assessed the U.S. capital markets and offered recommendations for enhancement.[2]

At the SEC, we took into account Treasury's work and that of the EMSAC just last month when proposing a pilot program for transaction fees. We recognized that a broad consensus of market participants believed we should test the impact of rebates and access fees on the quality of U.S. equity markets. Some market participants have been particularly concerned that access fees can create conflicts of interest that detract from their efforts to advance the interests of their customers – primarily Main Street investors. A pilot program should enable us to test these and other issues empirically. Once we have the data, we can evaluate potential regulatory action, including possible changes to Regulation NMS.

There are two other equity market structure initiatives that were recommended in the Capital Markets Report and received broad support from market participants. One is the Commission's 2015 proposal to enhance alternative trading system ("ATS") operational transparency. [3] Another is the SEC's 2016 proposal to enhance transparency of broker order routing practices. [4] I expect that the Commission will vote on these important transparency rules in the coming months. They embody the proven SEC approach of empowering market participants through material disclosures. Investors and market participants armed with more robust information about ATS operations and broker order routing practices should be able to make more informed decisions that reward those market participants that advance their customers' interests. But we also should consider whether additional transparency is needed in areas beyond ATS operations and broker order routing practices.

To that end, and reflective of my comments regarding the importance of input from market participants, the SEC's Division of Trading and Markets intends to host a series of staff roundtables devoted to specific equity market structure topics that have been raised to the Commission through the EMSAC, the Capital Markets Report, and otherwise. As currently envisioned, the initial roundtables will address the challenges associated with liquidity for thinly-traded securities, access to markets and market data, and regulatory approaches to addressing retail fraud. And further roundtables may follow.

Each roundtable will include a diverse set of expert panelists, representative of a broad range of viewpoints and interests, including those of retail investors. In addition, market participants and other interested parties can submit written comments on the roundtable topics. A general comment file for these roundtables will be available for interested parties to make their views on equity market structure issues known. [5] In addition to specific suggestions for any potential action, I invite the public to submit data and other information that may inform the Commission's analysis. [6] After the roundtables and considering the comments that may have been submitted, I would expect that our staff will have a clearer view of areas for improvement and what, if any, rulemaking proposals should be made to the Commission.

Brett Redfearn, Director of the SEC's Division of Trading and Markets, will follow me and provide more detail on the types of questions to be addressed at the first staff roundtables. In the remainder of my time, I will briefly touch on why I believe these areas deserve our attention.

Roundtable #1: Market Structure for Thinly-Traded Securities

First, I am pleased to announce today that the first of the SEC staff's roundtables will take place on April 23 and will address the market for smaller, more thinly-traded companies. The issue of facilitating capital formation and increasing the attractiveness of the public markets for smaller companies is one of my highest priorities as SEC Chairman. I am concerned that Main Street investors are bearing costs (and missing investment opportunities) as a result of the shrinking number of U.S.-listed public companies. [7]

Smaller companies, the securities of which are often relatively illiquid, play an essential role in our economy and may be the larger companies of tomorrow. Today, we have a single equity market structure for all companies, large and small, liquid and illiquid. I believe we should examine whether the current market structure meets the needs of all types of companies that have the potential to be public companies. For example, should a stock with only 30,000 shares of daily volume be regulated and traded in the same way as a company with 9.6 million shares of daily volume? [8] Said another way, there are 13 exchanges and more than 40 dark pools, as well as other market centers, and while microsecond speed may be a very efficient approach for the high volume company, is it an effective approach for all companies that have the potential to be public companies? I think this question needs consideration.

The Capital Markets Report highlighted many of these issues and recommended that the SEC consider allowing issuers of thinly-traded securities to suspend unlisted trading privileges, or UTP, for a stock so that it would trade on a smaller number of venues until liquidity reached a minimum threshold. I anticipate that this recommendation will receive close review at the staff's roundtable.

To be clear, I recognize the inherent trading volume challenges in less-active securities. The goal, however, is to identify pragmatic steps that should make it easier for buyers and sellers to find each other and consummate trades in smaller cap segments of the market.

Roundtable #2: Access to Markets and Market Data

I also anticipate that, later in the year, the Division of Trading and Markets will organize a staff roundtable that will focus on investor access to markets and market data. Various market participants have recognized that, as technology has advanced and markets have evolved, we have entered an era in which market participants have access to products and services, including market data feeds, that are diverse in nature, source and speed. This roundtable could address questions raised by such differential access, including fundamentally, whether our approach to this area is appropriate in terms of market efficiency, liquidity and fairness.

Noting my comments regarding retrospective review, this roundtable could also revisit some of the questions raised with Regulation NMS as initially proposed in 2004. To cite a specific example: are the judgments we made then with respect to SIP data [9] worth re-examining in light of numerous technical achievements and the related evolution of our markets, including changes in the corporate structure of stock exchanges from member-owned utilities to for-profit publicly traded entities?

It is appropriate at this point for me to note that proceedings currently pending before the Commission raise issues related to this differential access, and any roundtable on this topic would follow and I expect would address issues left open by the Commission's action in those matters.

Before moving on, I will make one additional point about governance of our marketplace and NMS plans. As many of you also know, I am concerned by the delays in the development and build of the Consolidated Audit Trail ("CAT"). Yes, as with any large scale project that involves a dynamic and growing system, issues that were not identified at the planning stage have arisen. That said, I have serious questions about how these issues have been and are being addressed. Comprehensive and readily accessible trade-level data is critical to effective market surveillance and regulation. Our current systems for accessing trade-level data are cumbersome and inefficient, and the CAT was intended to address those limitations. In other words, the CAT is important; and those charged with building the CAT, the SROs, are very capable: they are familiar with large data and technology projects and are, themselves as operators of self-regulatory organizations, responsible for ensuring the fair and efficient operation of our markets. If it clearly important and we have capable people on the job, why the delay? That is a good and important question. It is not a hypothetical question: It is a question that needs a prompt and effective solution.

Roundtable #3: Regulatory Approaches to Combat Retail Fraud

As we consider enhancements to equity market structure and market regulation more generally, we must continue to focus on the long-term interests of our Main Street investors. I believe combating

retail fraud is at the forefront of our mission. Thus, the Division of Trading and Markets will also organize a third roundtable later this year on this topic.

The roundtable will build on the very constructive discussion on this issue at the Commission's Investor Advisory Committee meeting last month. [10] I believe we must continually explore whether our regulatory approaches appropriately protect retail investors from fraud, including in the markets for digital assets and penny stocks. Just as with other areas of our mandate, I do not believe one size fits all here. Said more specifically, one year into this job, the relative propensity for fraud in the digital asset and penny stock markets continues to surprise and trouble me.

Conclusion

Many of the issues that I have touched on today are complicated and will be challenging to address, but these challenges are our opportunities. The time is right to take stock of the universe of information, data and perspectives provided through EMSAC recommendations, discussion in the Capital Markets Report, and otherwise, and then make choices about regulatory approaches going forward.

At the SEC, we need your engagement on all of these issues. Talk to us, and please do so with a perspective that reflects our mission: the protection of investors, maintenance of fair, orderly and efficient markets, and facilitation of capital formation. When we, and all market participants, focus on this mission and, critically, the long-term interest of our Main Street investors, everyone benefits.

Thank you.

---

[1] Materials relating to the Equity Market Structure Advisory Committee ("EMSAC"), including its recommendations and a list of subcommittees addressing various groups of issues, are available at https://www.sec.gov/spotlight/equity-market-structure-advisory-committee.shtml.

[2] U.S. Department of the Treasury, A Financial System that Creates Economic Opportunities: Capital Markets, Report to President Donald J. Trump (October 2017) ("Capital Markets Report"), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[3] Securities Exchange Act Release No. 76474 (November 18, 2015), 80 FR 80997 (December 28, 2015) (File No. S7-23-15).

[4] Securities Exchange Act Release No. 78309 (July 13, 2016), 81 FR 49432 (July 27, 2016) (File No. S7-15-16).

[5] In addition, the Commission's comment file on fixed income market structure issues continues to remain open at https://www.sec.gov/cgi-bin/ruling-comments.

[6] The Commission will post submissions on the Commission's Internet website. Submissions received will be posted without change; the Commission does not edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly. Because of this, if you have confidential data or other information that you wish to share with the Commission, you should submit that information in an aggregated or similarly anonymized format.

[7] SEC staff estimate a reduction in the number of companies listed publicly in the United States of nearly 50% between 1996 and 2017, using data from the Center for Research in Securities Prices US Stock and US Index Databases© 2017 Center for Research in Securities Prices (CRSP), The University of Chicago Booth School of Business. Further, based on World Bank Development Indicators (*available at* https://data.worldbank.org/indicator ,) approximately 10% of public companies globally were listed in the United States as of 2016, compared to approximately 20% in 1996.

[8] Based on SEC staff analysis, the average daily volume of the 100th most heavily traded company (ranked on average daily volume) during the fourth quarter of 2017 was 9.6 million shares.

[9] The Security Information Processors ("SIPs") link the U.S. markets by processing and consolidating all protected quotes and trades from every trading venue for an NMS stock into a single data feed.

[10] Discussion of Regulatory Approaches to Combat Retail Investor Fraud, Panel Topic at the March 8, 2018 Meeting of the SEC Investor Advisory Committee, webcast *available at* https://www.sec.gov/video/webcast-archive-player.shtml?document_id=030818iac.