

“U.S. Capital Markets and the Public Good” Prepared Remarks before SEC Speaks



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Thank you, Erik, for that kind introduction. As is customary, I'd like to note that my views are my own as Chair of the Securities and Exchange Commission, and I am not speaking on behalf of my fellow Commissioners or the staff.

Upon passage of the Securities Act of 1933, President Franklin Roosevelt and Congress knew their job wasn't done. While they knew the "Truth in Securities Act" was consequential, Roosevelt and Congress understood it had not yet dealt with key problems in the securities markets.

The 1920s was a time when markets were rife with fraud and manipulation. This led to a fundamental breakdown of trust in the capital markets.

Congress responded with the Securities Exchange Act of 1934. They also set up the Securities and Exchange Commission, embedding the word "Exchange" right in our name.

There was much debate about these reforms.

Sam Rayburn, then Chair of the Commerce Committee and later Speaker of the House, said the legislation was being considered "under the pressure of the most vicious and persistent lobby that any of us have ever known in Washington."^[1]

Congressman Fred Britten, speaking about Rayburn's legislation, argued that "the real object of the bill is to Russianize everything."^[2]

Given such opposition, naturally the final bill had a series of compromises. At its core, though, it was about enhancing the integrity of and building trust in our capital markets through the oversight of exchanges, broker-dealers, and the trading of securities in secondary markets.

As Joe Kennedy, the first Chair of the SEC said so eloquently, "[T]he community thus exposed to fraud and manipulation should welcome the Securities and Exchange Act of 1934 and the Commission it created."^[3]

It was four decades later that Congress and President Gerald Ford came back with significant reforms to promote efficiency and competition in the capital markets.^[4]

Congress was addressing problems related to fixed commissions. They were reacting to the back office "Paperwork Crisis" of the 1960s. There were issues resulting from emerging technologies. There also were challenges regarding how self-regulatory organizations (SROs) set their rules.

Through the Securities Acts Amendments of 1975,^[5] Congress for the first time gave the SEC authority to establish a National Market System for securities transactions. They gave the SEC authority for a national quoting system for securities. They gave us authority over the clearance and settlement of securities transactions. Further, they gave us new and revised authority regarding review and setting of SRO rules.

Congress found, as articulated in section 11A, that it was in the public interest and for the protection of investors to assure “fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets.”^[6] Congress inserted the word competition in 20 places in the securities laws.

Two Congresses and two Presidents, Roosevelt and Ford, understood how important our capital markets are to investors, issuers, and more broadly to our economy. They were focused on two key public goods: first, instilling greater trust, and second, instilling greater efficiency and competition in the capital markets.

Promoting trust in the capital markets by reducing fraud and manipulation benefits investors and issuers alike. Such trust means more investors are willing to invest in the markets with confidence. It means issuers can rely on the markets to price their offerings. Well-functioning markets provide price discovery that helps capital flow to its most productive uses.

Efficiency and competition mean the central functioning of the capital markets is less costly, so investors get better returns. Issuers can raise money more efficiently. When market participants know that they can get a competitive price when selling or buying, they are more likely to invest in the primary market in the first place. Moreover, competition and efficiency allow prices to come closest to fundamental value, aiding price discovery and capital formation.

Efficiency and competition also promote another externality—greater depth of liquidity in the markets. As they say, liquidity begets liquidity.

Congress understood these public goods could not be achieved by private markets on their own. Private incentives are likely insufficient when it comes to setting rules for the capital markets. Well-functioning markets create positive externalities for the American public that aren’t fully internalized by private entities. Leaving it to the private markets alone would lead to under-investment in policies that best promote trust, efficiency, and competition.

Thus, the SEC has an important role to play. The need to promote these public goods is constant. Given everchanging technology and business models, though, we have an obligation to update the rules of the road, always with an eye toward promoting trust as well as efficiency, competition, and liquidity in the markets.

With the emergence of the internet, under Chair Arthur Levitt, the Commission in 1998 comprehensively defined “exchange” under SEC rules and adopted a framework for alternative trading systems (ATs).^[7]

Under Chair Bill Donaldson, the Commission updated the National Market System rules in 2005.^[8] Chair Donaldson said at the time: “We are addressing a complex set of problems that have lingered in the marketplace for years, that have caused substantial discord among market participants and that have resulted in inferior outcomes for investors.”^[9]

Clearance and Settlement

In the 1975 reforms, Congress added Section 17A to the Securities Exchange Act and directed the SEC to fulfill an important role overseeing securities clearinghouses. Later, in 1986—after a dozen nonbank Treasury dealers failed, sending shudders into the banking system—Congress broadened the SEC’s authority to include clearinghouses in the Treasury markets.

Clearinghouses are vital to our capital markets. They facilitate what one might call the market plumbing, that which happens after you execute a transaction through the time that it settles. Standing in the middle of the securities markets, clearinghouses are the buyer to every seller and the seller to every buyer.

A bit of history might surprise everyone, but the U.S. stock market settled at T+1 well into the 1920s. It was only with increasing volumes that the market plumbing was lengthened to a business week after a transaction (T+5).

It took the Stock Market Crash of 1987 before the Commission implemented our first settlement rule in 1995. That's when we shortened the settlement cycle to three business days after the trade date.^[10] We shortened it to two business days after the trade date in 2017.^[11] Last year, we adopted rules to shorten it to one business day, which will be implemented on May 28, 2024.^[12]

I would note our U.S. government securities market has been on a T+1 settlement cycle ever since we started central clearing of U.S. treasuries in 1986. We also have a T+1 settlement cycle in securities options markets, much of the derivatives markets, and as the normal practice for certain mutual funds.^[13]

Thus, on May 28, we're aligning the rest of the U.S. securities markets to T+1. I encourage all market participants to ensure that they are ready for the upcoming transition.

We also adopted rules in December 2023 to facilitate additional central clearing for the \$27 trillion U.S. Treasury markets.^[14] The final rules make changes to enhance customer clearing and broaden the scope of which transactions clearinghouse members must clear. Enhanced access to central clearing can facilitate all-to-all trading, competition, and resiliency in these markets. These rules help fulfill Congress's mandates to promote efficiency, competition, liquidity, and resiliency in the markets.

Exchanges and Alternative Trading Systems

A lot has changed in the capital markets in the 26 years since Chair Levitt's Commission adopted Regulation ATS. Electronification and new methods of trading have advanced significantly. Much of the secondary markets in Treasuries is facilitated by interdealer broker (IDB) electronic platforms. Further, principal-trading firms have been participating to a greater degree, representing approximately 61 percent of the volume in 2019 on the IDB platforms in the Treasury markets.^[15]

The growing importance to investors and the overall market structure of exempted platforms led to the Commission, under Chair Jay Clayton, to put out a proposal with regard to ATSs for government securities and a concept release on fixed-income market structure.^[16]

Based upon public input, in 2022, we repropose rules for ATSs for government securities and proposed to modernize the definition of an exchange.^[17] Commenters had noted that much of secondary market trading in Treasuries and corporate bonds also were facilitated by request-for-quote (RFQ) electronic platforms between dealers and customers.

In particular, the Commission in 2022 sought feedback on whether the definition of an exchange should include platforms, such as RFQ platforms, that perform exchange-like functions in the Treasury markets and elsewhere. While they may not have central limit order books, these are venues where multiple buyers can meet multiple sellers, use structured methods to negotiate a trade, and can agree to the terms of a trade.

Ensuring that such exchange-like platforms follow our exchange-specific rules could benefit investors and markets alike.

National Market System

In terms of the National Market System, a great deal has changed since we adopted Regulation NMS in 2005. In particular, a large and growing amount of equity trading now occurs in what many call the dark markets, particularly off-exchange market centers such as wholesalers and dark pools.

Trade volumes went up about twofold to 11 billion shares per day from 2007 to 2023.^[18]

The one-penny minimum increment used for quoting is outdated, and too wide for many of the securities trading in today's markets. Thus, we proposed a rule to narrow the minimum tick size, making it smaller than a penny for many securities.^[19]

The proposal also would update the more than 120-year-old definition^[20] of round lot^[21] by determining the size of round lots by the share price. The proposal also would add quotes on odd-lots to core data.

Further, it would bring greater transparency to the access fees charged and related rebates paid by exchanges. In addition, it would lower what exchanges may charge investors to access protected quotes.

The Commission also proposed rules last fall regarding exchanges' volume-based transaction rebates and fees.^[22]

Currently, midsized and smaller exchange member broker-dealers effectively pay higher fees than larger members to trade on most exchanges. Members with the largest trading volume receive the largest rebates and thus pay the lowest net fees.

Best Execution

I've long considered broker-dealers' best execution duty to their customers to be critical to both trust and competition in the markets.

Thus, I was surprised to learn when I came to the SEC that the Commission actually didn't have its own best execution rule. The best execution rule was instituted, instead, by the Financial Industry Regulatory Authority (FINRA), an SRO, and it was last updated in 2014.^[23] The Municipal Securities Rulemaking Board (MSRB), another SRO, implemented its first best execution rule for municipal securities in 2016.^[24]

I believe a best execution standard is too central to the SEC's mandate to protect investors, not to have on the books as a Commission rule.^[25] Rapid developments in our markets make best execution that much more important.

Order Competition and Execution Quality

Every day, investors turn to broker-dealers in the markets—often through brokerage apps—to build a better financial future.

How do you know, however, the quality of the broker's execution of your order? You can turn to measures that compare the price you received with what's called the National Best Bid and Offer at a particular time.

This information is measurable, but historically the brokers whose apps you're using haven't been required to disclose execution quality in that way.

Thus, last month we finalized rules to require that large broker-dealers—those with more than 100,000 customers—disclose execution quality to the public.^[26]

We also proposed a rule in 2022 regarding exposing marketable orders of individual investors of a certain size to fair and open auctions.^[27]

About 90 percent of individual investors' marketable orders in NMS stocks are routed to a small group of off-exchange wholesalers, operating in the dark market. That doesn't seem to promote the greatest competition or fairness.

We've received a lot of feedback on this proposal and are considering all of the comments.

Conclusion

The U.S. capital markets are a national asset. Trust in the markets is a public good. Capital market efficiency, competition, and liquidity are public goods.

Roosevelt and Congress understood this in the 1930s. Ford and Congress understood this in the 1970s.

They also understood that the need for the SEC to promote these public goods is evergreen. Technology and business models, though, are everchanging.

Thus, as we have done for 90 years, we will continue to update rules of the road for investors and issuers alike.

[1] See Congressional Record, Volume 78, Part 7, 73rd Congress, second session (April 30, 1934), page 7693, available at <https://www.congress.gov/bound-congressional-record/1934/04/30/house-section>.

[2] See St. Louis Federal Reserve, Full text of Commercial and Financial Chronicle: May 5, 1934, Vol. 138, [No. 3593], available at <https://fraser.stlouisfed.org/title/commercial-financial-chronicle-1339/may-5-1934-517150/fulltext>.

[3] See Joseph P. Kennedy, Chairman, address at Meeting of the Boston Chamber of Commerce (Nov. 15, 1934), available at <https://www.sec.gov/news/speech/1934/111534kennedy-1.pdf>.

[4] See John G. Gillis, Financial Analysts Journal, Vol. 31, No. 5 (Sept.-Oct. 1975), pp. 12-15, available at <https://www.jstor.org/stable/4477857?seq=1>; See also Philip A. Loomis, Jr., Commissioner, address at Joint Securities Conference (Nov. 18, 1975), available at <https://www.sec.gov/news/speech/1975/111875loomis.pdf>

[5] P.L. 94-29 (June 4, 1975), available at <https://www.congress.gov/94/statute/STATUTE-89/STATUTE-89-Pg97.pdf>.

[6] See 11A(a)(1)

(1) The Congress finds that—

(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure—

(i) economically efficient execution of securities transactions;

(ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors' orders in the best market; and

(v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders. available at <https://www.law.cornell.edu/uscode/text/15/78k-1>.

[7] See Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998), (Regulation ATS Adopting Release), available at <https://www.federalregister.gov/documents/1998/12/22/98-33299/regulation-of-exchanges-and-alternative-trading-systems>.

[8] See Securities and Exchange Commission, "Final Rule Regulation NMS" (June 9, 2005), available at <https://www.sec.gov/rules/2005/06/regulation-nms>.

[9] See William H. Donaldson, "Opening Statement at Commission Open Meeting of April 6, 2005, re: Regulation NMS" (April 6, 2005), available at <https://www.sec.gov/news/speech/spch040605whd-nms.htm>.

[10] See Securities and Exchange Commission, "Securities Transactions Settlement" [Release No. 33-7022; 34-33023; IC-19768; File No. S7-5-93] (Oct. 13, 1993), Pages 52891-52909, available at https://archives.federalregister.gov/issue_slice/1993/10/13/52889-52917.pdf.

- [11] See Securities and Exchange Commission, "SEC Adopts T+2 Settlement Cycle for Securities Transactions" (March 22, 2017), available at <https://www.sec.gov/news/press-release/2017-68-0>.
- [12] See Securities and Exchange Commission, "SEC Finalizes Rules to Reduce Risks in Clearance and Settlement" (Feb. 15, 2023) available at <https://www.sec.gov/news/press-release/2023-29>.
- [13] It is T+1 when trading directly with the fund family or the fund's transfer agent. When trading a mutual fund through a broker, it is T+2 settlement.
- [14] See Securities and Exchange Commission, "SEC Adopts Rules to Improve Risk Management in Clearance and Settlement and Facilitate Additional Central Clearing for the U.S. Treasury Market" (Dec. 13, 2023), available at <https://www.sec.gov/news/press-release/2023-247>.
- [15] See Federal Reserve, "Principal Trading Firm Activity in Treasury Cash Markets" (Aug. 4, 2020), available at <https://www.federalreserve.gov/econres/notes/feds-notes/principal-trading-firm-activity-in-treasury-cash-markets-20200804.html>.
- [16] See Securities and Exchange Commission, "SEC Proposes Rules to Extend Regulations ATS and SCI to Treasuries and Other Government Securities Markets" (Sept. 28, 2020), available at <https://www.sec.gov/news/press-release/2020-227>.
- [17] See Securities and Exchange Commission, "SEC Proposes Amendments to Include Significant Treasury Markets Platforms Within Regulation ATS" (Jan. 26, 2022), available at <https://www.sec.gov/news/press-release/2022-10>.
- [18] See CBOE "Historical Market Volume Data," available at https://www.cboe.com/us/equities/market_statistics/historical_market_volume/.
- [19] See Securities and Exchange Commission, "SEC Proposes Rules to Amend Minimum Pricing Increments and Access Fee Caps and to Enhance the Transparency of Better Priced Orders" (Dec. 14, 2022), available at <https://www.sec.gov/news/press-release/2022-224>.
- [20] See Merriam-Webster, "Round Lot," which places the first known use of round lot circa 1902, available at <https://www.merriam-webster.com/dictionary/round%20lot>. See also DeCoppet & Doremus, "Buying and Selling Odd-Lots" (1933), available at <https://www.bullmarketgifts.com/Buying-and-Selling-Odd-Lots-1933-p/od326.htm>. As the bookseller explains, "This booklet was published in 1933 by DeCoppet & Doremus, who were Odd-Lot Dealers on the New York Stock Exchange and member of the Exchange. At the time, shares on the NYSE were traded in multiples of 100, known as 'Round-Lots.'"
- [21] Round lots are quotes for 100 shares.
- [22] See Securities and Exchange Commission, "SEC Proposes Rule to Address Volume-Based Exchange Transaction Pricing for NMS Stocks" (Oct. 18, 2023), available at <https://www.sec.gov/news/press-release/2023-225>.
- [23] See FINRA, "Best Execution," available at <https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/best-execution>.
- [24] See MSRB "Implementation Guidance on MSRB Rule G-19, on Best Execution" (Nov. 20, 2015), available at <https://www.msrb.org/sites/default/files/Best-Ex-Implementation-Guidance.pdf>.
- [25] See Securities and Exchange Commission, "SEC Proposes Regulation Best Execution" (Dec. 14, 2022), available at <https://www.sec.gov/news/press-release/2022-226>.
- [26] See Securities and Exchange Commission, "SEC Adopts Amendments to Enhance Disclosure of Order Execution Information" (March 6, 2024), available at <https://www.sec.gov/news/press-release/2024-32>.
- [27] See Securities and Exchange Commission, "SEC Proposes Rule to Enhance Competition for Individual Investor Order Execution" (Dec. 14, 2022), available at <https://www.sec.gov/news/press-release/2022-225>.

