

MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: February 25, 2014

Subject: February 28, 2014, Subcommittee on Capital Markets Entitled “Equity Market Structure: A Review of SEC Regulation NMS”

The Subcommittee on Capital Markets and Government Sponsored Enterprises will hold a hearing entitled “Equity Market Structure: A Review of SEC Regulation NMS” at 9:30 a.m. on Friday, February 28, 2014, in room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- The Honorable Roel Campos, Partner, Locke Lord LLP; former SEC Commissioner, 2002-2007
- Steven Lofchie, Partner, Cadwalader, Wickersham & Taft LLP
- Erik R. Sirri, Professor of Finance, Babson College; former Director of SEC Division of Trading and Markets, 2006-2009
- Chester Spatt, Professor of Finance, Tepper School of Business, Carnegie Mellon University; former SEC Chief Economist, 2004-2007

Background

In 1975, Congress passed the Securities Acts Amendments directing the Securities and Exchange Commission (SEC) to address a variety of issues regarding the structure of U.S. equity markets. In particular, Congress added Section 11A to the Securities Exchange Act of 1934 (Exchange Act), which mandated that the SEC facilitate the establishment of a national market system to link together – through data processing and communications technologies – the multiple individual markets that trade securities.¹ The primary objectives of this new national market system were to make executions of securities transactions more economically efficient; to promote fair competition among markets and securities firms; to improve the availability of market information to investors; to ensure that orders are executed in the best market; and to direct interaction among investor

¹ See Regulation NMS, Securities and Exchange Commission Rel. No. 34-51808 (June 9, 2005).

orders.² Over the next three decades, the SEC made a number of significant regulatory changes aimed at fulfilling its mandate under Section 11A of the Exchange Act. These changes include, among others, the Order Handling Rules in 1996, Regulation Alternative Trading System in 1998, decimalization in 2000, and Regulation National Market System (Reg. NMS) in 2005.

Reg. NMS includes four main provisions designed to strengthen and modernize the regulatory structure governing U.S. equity markets. The Order Protection Rule or “Trade-Through” Rule requires trading centers to establish policies and procedures reasonably designed to ensure that investors’ trades are not executed at prices inferior to protected quotations (*i.e.*, quotations that are immediately and automatically accessible) being displayed by other trading centers. The Access Rule is designed to ensure that trading facilities operated by self-regulatory organizations (SROs) provide fair and non-discriminatory order execution to both members and non-members. The Sub-Penny Rule prohibits market participants from displaying, ranking, or accepting a bid or offer, or an order in an NMS stock, that is priced in an increment less than a penny (\$0.01), unless the price of the stock is lower than \$1.00, in which case the minimum allowable increment is \$0.0001. The Market Data Rules provide a new formula for allocating revenues to SROs for disseminating market information that are based on trades and quotations, rather than solely on trades.³ Reg. NMS was fully implemented in 2007.

The effects of Reg. NMS on equity market structure and quality continue to be the subject of ongoing debate, with a particular focus on the Order Protection Rule. While investors today can take advantage of a variety of competing trading venues and historically low transaction costs, some market participants and press reports have recently identified Reg. NMS as a potential source of market complexity, dislocation, and disruption. Over the last five months, SEC Chair White and all four other Commissioners have publicly supported the need to examine U.S. equity market structure and the regulatory regime governing these markets, including Reg. NMS.⁴ In light of these developments, this hearing will examine Reg. NMS, its objectives and outcomes on the U.S. equity markets.

² See Testimony of William H. Donaldson Before the Subcommittee on Securities and Investment of the Senate Committee on Banking, Housing, and Urban Affairs (Oct. 15, 2003).

³ See *generally* Reg. NMS, SEC Rel. No. 34-51808.

⁴ See, *e.g.*, “Focusing on Fundamentals: The Path to Address Equity Market Structure,” Remarks by Chair Mary Jo White before the Security Traders Association 80th Annual Market Structure Conference (Oct. 2, 2013); “Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation,” Remarks by Commissioner Daniel M. Gallagher before the Securities Industry and Financial Markets Associations’ 15th Annual Market Structure Conference (Oct. 4, 2012); “Seeing Capital Markets Through Investor Eyes,” Remarks by Commissioner Luis A. Aguilar before the Consumer Federation of America’s 26th Annual Conference (Dec. 5, 2013); “The Benefit of Hindsight and the Promise of Foresight: A Proposal for A Comprehensive Review of Equity Market Structure,” remarks by Commissioner Michael S. Piwowar before the 2013 Global Trading and Market Structure Conference (Dec. 9, 2013); Remarks by Commissioner Kara M. Stein before the Trader Forum 2014 Equity Trading Summit (Feb. 6, 2014).