

**Testimony of  
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**Before the Capital Markets and Government Sponsored Enterprises Subcommittee  
Committee on Financial Services  
U.S. House of Representatives**

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Chairman Garrett, Ranking Member Waters and Members of the Subcommittee:

The Security Traders Association (STA) welcomes the opportunity to present comments before the Subcommittee on Capital Markets and Government Sponsored Enterprises on: “Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors”.

The STA was formed in 1934. We are an organization of individuals who are involved in the trading of financial securities. Our membership is diverse, both geographically and in the roles we fulfill in the market place. Much of our testimony today will reference years of comment letters STA has written on market structure; letters which were the culmination of input received from a wide range of market participants. The testimony of the STA over the years has accurately informed and alerted Congress and the Securities and Exchange Commission (SEC) to the possible consequences, both intended and unintended, of proposed changes to market structure. We are pleased to have the opportunity to do so today.

Our testimony will focus on three areas of concern STA has with today’s market structure: investor confidence; capital formation; and the quality of regulation. We will also identify specific areas which we, as practitioners, view are the primary forces causing our concerns: operational capability; decimalization; and the rule making process for both Self-Regulatory Organizations (SROs) and the SEC.

**Investor Confidence; Operational Capability**

Investor confidence is influenced by several factors, none more than the operational capability of the markets. Failures of that capability, even as a rare or limited occurrence, destroy investor confidence, much more so than any other regulatory or market structure minutia. Fostering greater operational capability should be the foremost consideration of any regulatory or legislative entity that has oversight or influence on our financial markets. It is imperative that such entities ensure no demands are made on the operational capacity of the industry that result in its being unable to deliver the services it purports to offer. Furthermore, behavior which stresses the operational capability of our markets should be identified and reviewed by the proper regulatory agency. Our markets need to be open to serve a wide range of market participants with varying business models. Therefore, it is critical that behavior which is deemed potentially harmful to the overall operational capability of our markets not be allowed to exist unimpeded.

**Quality of Regulation and the Rulemaking Process for SROs and SEC**

Today, rules governing the securities markets are introduced to the marketplace by SEC initiatives in the form of rule proposals, or the rule filings of the Self-Regulatory Organizations submitted to the SEC for approval. SEC approval of SRO rules, and SRO rules in certain cases that are effective upon filing, presents unique problems. While there are similarities in these processes, they are distinct and vary primarily in the level of due diligence required of the Commission. There are efficiencies within both processes that when applied properly serve the

competitive nature of our markets and investor confidence. Our concerns reside in the lack of criteria that are used in deciding which process better serves investor confidence when rules are proposed.

As stated in our letter to the Commission on June 8, 2012:

STA acknowledges that the right of exchanges to compete is often exercised through the SRO rule filing process. While STA sees certain efficiencies and benefits which accrue to investors in this process, we have become concerned that the pattern of one SRO rule approval is often followed by similar, but different Rule filings by competing SROs. This trend has the potential to affect overall market structure and investor confidence. We strongly urge the Commission that when considering the impact to market structure with a single SRO Rule Proposal, it does so under the assumption that competing SROs will file similar proposals.

The Commission should consider alternative approaches to the approval of important SRO rule proposals that have material market-wide implications on the structure of the market. Rather than picking and choosing between the proposals or in the alternative, approving all of them, in cases where multiple rule filings are made that are identical or very closely related or where the SRO rule filings have material market-wide implications, the Commission should consider substituting a proposal for a uniform, market-wide SEC rule in lieu of those of the SROs. STA does not suggest that changes to fee structures or other SRO proposals that attempt to differentiate themselves would merit a uniform SEC approach. Instead, the Commission should propose uniform, market-wide rules when there are significant market-wide implications.

For example, the NYSE Retail Liquidity Program (RLP) proposal would, among other things, allow sub-penny quoting, and if approved, other exchanges have suggested they would submit similar filings. This would lead to a significant market structure event – one that includes sub-penny quoting and its implications on increased message traffic and market data charges, which would lead to increased technology and market data costs, as well as potential confusion by investors. Rather than an SRO rule, a sub-penny quoting proposal should be an SEC initiative due to its market-wide implications. Adopted pursuant to the requirements of the Administrative Procedures Act that insure the public has adequate notice and an opportunity to comment on the proposal, the resultant efficiency of a single proposal should produce a greater volume of focused expert analysis and input as to any difficulties in complying with the proposal, the costs of doing so, and the likely impact on the overall evolution of market structure. Competing SROs will undoubtedly comment on the proposed SEC rule, suggesting changes that reflect what was originally proposed in their individual rule filing. The SEC may adopt or reject these suggestions but importantly, experience has shown that minor modifications adopted in individual rule filings have not increased competition among the marketplaces that justifies the significant complexity they add to the compliance burdens and demands on the operational capacity of industry users.

STA believes that in addition to the review of the specifics of SEC and SRO rule proposals, the quality of regulation would be improved and investor protection served if the SEC addressed the increased need for industry input on technology and back office operations in its rule approval process. The existing rule review and approval process is increasingly ill-suited to obtaining this information. For example, in its comments on the Consolidated Audit Trail proposal, the STA stated:

In order for CAT to effectively meet its objectives, STA believes that extensive business analysis is needed that will require expertise in order, trade and post-trade systems and processes. Such an analysis will require many detailed discussions between SEC staff, the SROs and industry participant teams.

We submit that the SEC needs to take formal action on regulations, and particularly before adopting those imposing significant technological or operational burdens on the markets, to create advisory or implementation committees as permitted by law to ensure it receives input from the trading community, including experts in trading systems and products, and develops an understanding of the operational demands of the proposed rules. We are encouraged that

in the adoption of the limit up-limit down pilot program, the SROs responded to STA's recommendation to establish an Advisory Committee, which is to be composed of a broad cross-section of market participants who may submit views on matters relating to the limit up-limit down plan.

In today's exceedingly high tech equity and derivative markets, where massive amounts of data are created and utilized by market participants and investors, every rule proposal by the Commission represents a complex administrative and compliance project for the industry. The STA is concerned that consideration and approval of these rules often takes place without adequate input to, and consideration by, the Commission concerning the technical difficulties, costs, and cost-benefit analysis associated with them. This problem is exacerbated, in the case of an SRO rule filing, by the fact that SEC approval of the rule will often result in multiple filings by competitor SROs with similar but perhaps not identical proposals. It is necessary, therefore, for the SEC to not only consider these proposals on their own merits, but to include in its analysis the likely multiplication of complexity, technological demands, and costs and benefits on a market wide basis.

Finally, Commission rule review and approval would be improved if more attention was paid to possible "unintended consequences" in connection with the approval of a rule. No one can predict the future, but experts can often demonstrate the most likely outcomes of some changes, and traditionally the SEC has not given much weight to such testimony, preferring instead to approve a rule and allow competition to decide whether it will work efficiently or not.

### **Decimalization; Capital Formation; and Investor Confidence**

There is perhaps no single market structure event that has yielded more benefit to retail investors who transact directly with the market to buy or sell securities than the introduction of decimal prices. The benefits for this class of investor are witnessed every day in the narrow bid to ask spreads in the securities in which they trade. The data which shows the implicit savings to investors brought about by narrow spreads becomes even more impressive when it shows that even during moments of volatile markets, spreads remain tight.

This benefit, which was immediate and long lasting, however, has come with a cost to the secondary markets ability to perform their capital formation function. In its letter to the Commission on May 14, 2003, STA wrote:

The raising of equity capital by corporations is the cornerstone of our economy. However, given the recent regulatory events surrounding research and investment banking and market structure changes affecting trading, the raising of capital has become exceedingly more difficult. That, in turn, is impacting the U.S. economy and its ability to create jobs.

Action must be taken soon to remedy what could be soon a capital formation crisis. A re-examination of decimalization is a good place to start.

Members of this panel, we reiterate, this letter was written, May 2003.

The unintended consequences of decimalization have been dramatic, most noticeably, in the significant decline in the quantity of liquidity providers in the stocks of smaller and medium sized companies and those with less than active trading markets. Shareholders benefit from the presence of liquidity providers. They dampen market volatility to the benefit of the marketplace and investor confidence. 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.

One way to conduct such an examination is through a Commission initiated pilot program utilizing a statistically significant number of small and middle capitalization company securities to study the impact on the secondary markets of quoting and trading securities in pricing increments of greater than one penny. Should the Commission move ahead with such a pilot program, a key data point that should be measured is whether private investors recognize and are willing to accept additional incremental costs in return for the opportunity to obtain the potential for greater growth characteristic of successful small- and mid-size companies.

Thank you and I look forward to answering any of your questions.