

WILLIAMS & JENSEN, PLLC

Fr: Eric Robins

Re: STA's 79th Annual Market Structure Conference- SEC Commissioner Troy A. Paredes and CFTC Commissioner Jill Sommers

Dt: September 21, 2012

At a September 21 Security Traders Association (STA) [event](#), SEC Commissioner Troy A. Paredes and CFTC Commissioner Jill Sommers discussed their insights on the joint rulemaking procedures by the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC). Former Co-Director of SEC Trading & Markets, Jamie Brigagliano, served as the moderator for the panel.

Panelists addressed questions on: (1) fragmentation; (2) trading spreads; (3) high-frequency trading; (4) protection of customer funds; and (5) regulation of OTC Derivatives.

Questions and Answers

Fragmentation

Brigagliano noted that the futures markets are centralized, but the equities markets are characterized by liquidity disbursed in multiple markets. **Paredes** observed that fragmentation is usually described as troubling, but he explained his view of it as competition and choice. He stated that it allows access to the markets and products that best fit the needs of different investors. He suggested that such issues should be examined through what data says about the markets. He acknowledged that fragmentation can present some challenging issues, but that it is important to recognize the promise of competition.

Trading Spreads

Brigagliano noted that spreads have been reduced and trades have been executed quite quickly. He noted that OTC trading and internalization has resulted in benefits. But he questioned whether multiple venues complicate regulatory solutions such as with the post flash crash remedies. He asked if it is harder to add any safeguards that regulars want to add when the market is so complex. **Paredes** replied in the affirmative, adding that this makes it more complicated. He claimed it is tougher to diagnose what the issues are. But he claimed that a starting point is to make sure regulators have good data to ensure well-calibrated responses, and that is important to add staff with quantitative skills. **Brigagliano** noted that both the SEC and CFTC have taken steps to handle the data.

High-Frequency Trading

Brigagliano noted that the CFTC and the SEC have undertaken a lot of work on algorithmic trading. He asked whether market quality could be measured. **Sommers** noted the migration to electronic trading from floor trading, with only options trading occurring on the floors of exchanges. She noted that CFTC Commissioner Scott O'Malia chairs the Technology Advisory Committee (TAC), which has tried to define high frequency trading (HFT), as well as examine co-location and algorithms (and the relationship to speed and DCM core principles). She noted that staff from the

CFTC is in the process of drafting a concept release on this issue and the Commission will be looking at this issue for some time as well as continuing to coordinate with the SEC on this. She asserted that there was a need to institute risk controls globally, and not in a vacuum. **Paredes** claimed that the SEC roundtable on October 2 is an effort to advance the SEC's understanding of these issues. He stated that there was a need to know what is at risk and try to remedy it from going too far. He claimed that the improvements in technology were a good thing, and that nothing can be perfect with human involvement. He claimed it was important to not lose sight of the data and the economic literature regarding HFT, noting the importance of examining the relationship between HFT and liquidity in the markets.

Paredes also asserted that when glitches in technology occur, it is in no one's interest for that to happen, so it allows the government response to consider market based solutions such as best practices.

Protection of Customer Funds

Brigagliano inquired about the protection of customer funds, to which **Sommers** replied that incidents have caused the CFTC to examine whether FCM segregation of funds needs to be strengthened. She claimed that the futures regime is quite simple in that the FCMs are to segregate customer funds from proprietary funds and deposits must be in an account belonging to customers. She noted that the CFTC is in the process of proposing a customer funds rule which could be out in the next few weeks. This rule could include enhancements to depository letters, regulators having read-only access to accounts, and requiring FCMs to adopt policy and procedures regarding these firms. She further suspected that Congress would be looking to changes to the bankruptcy regimes. **Paredes** claimed that there is no doubt that the protection of customer funds is needed and that the examination and inspection function is critical. He suggested that the issue is how to deal with registrants. He asserted that OCIE has looked to have a more risk-based and data-driven approach and that the SEC divisions overall need to allocate the resources in a more effective way. He also stated the importance of making sure investors have the information they need to protect themselves, citing the "sobering" SEC report on financial literacy of investors.

Regulation of OTC Derivatives

Brigagliano noted that the Dodd-Frank Act calls for the implementation of a regulatory regime for OTC derivatives. He asked about the progress of this implementation. **Commissioner Sommers** explained that the CFTC has proposed over 60 rules and finalized over 40 of them. She stated that the CFTC was trying to integrate the rules but explained that the challenge comes to see if this works. Noting the deadline of October 12 for when the definition of "swap" becomes effective, she expects that until that time the CFTC will issue no-action letters, provide more frequently asked questions (FAQs) and answer notices, and provide other forms of relief. She also noted that the CFTC was in the midst of dealing with its foreign counterparts and noted the concerns raised by other regulators abroad. She stated that the CFTC has yet to finalize certain swap trading rules (such as those relating to swap execution facilities (SEFs), make available for trading and block trades) and may not do so until next year. She noted that the segregation for cleared swaps goes into effect next year. **Commissioner Paredes** added that even after rules are in place, some of the refinements needed may require FAQs, exemptive relief, or even amendments to the existing rules. He contended that regulatory uncertainty and lack of predictability impact the marketplace. He claimed that even after the rules are in place, the SEC needs to undertake a retrospective review and

analysis of its rules (such as who is a security-based major swap participant), suggesting that a first attempt at a rule is not likely to be perfect. With data analysis, he claimed that the SEC would have more certainty in their review of rules.