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SEC Reform: The Doughnut and the Hole

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There is a new sheriff on the street – Wall Street, that is. And, it is not a fresh faced replica of Preet Bharara. Rather, President Trump has picked Jay Clayton, a Sullivan & Cromwell power puncher for Wall Street's most prominent, to serve as the Agency's next Chairman. The Commission drew the long straw with Clayton. He is a capital markets expert whose core competency lies comfortably with the Securities Act of 1933 and its sister, the Securities and Exchange Act.

Clayton will likely begin his term by focusing on "regulatory reform." Reform for the SEC is ripe for the picking. The Agency was created out of the chaos that followed the October 29, 1929 stock market crash. Its animating spirit, according to then-President Franklin D. Roosevelt, was to create an entity to protect investors by "safeguarding of values, and so far as it may be possible, . . . eliminate[ing] . . . unnecessary, unwise and destructive speculation."[1]

The newly-created Commission lived up to its tout by, among other things, creating a registration and reporting regulatory scenario based upon disclosure principles and an enforcement function aimed at frustrating fraudsters. While these regulatory initiatives hit the proverbial spot – bringing integrity to the market at a time when wary investors needed to be convinced that it was safe to invest – of late it seems that the Commission has lost its way. As the Center for Capital Markets Competitiveness concluded in a December 2011 report, the "SEC regulatory and enforcement structures have failed to keep pace with rapidly changing markets."[2]

The Commission's registration and reporting requirements have become a complicated maze that requires corporations to employ hordes of professionals to assist with even the simplest of transactions. While the Enforcement Division regularly regales with its record-breaking number of enforcement actions, these numbers are enhanced by the adoption of a "broken windows" enforcement policy that punishes the insubstantial at the cost of glossing over more substantive issues. The Commission has allowed (and even encouraged) fragmentation to overtake the market in the guise of competitiveness and speed, resulting in a market that lacks transparency and accountability. As former New York Stock Exchange CEO Duncan Neiderauer stated in 2012: "It's important that we

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1 Franklin D. Roosevelt, "Message to Congress Recommending a Securities Exchange Commission," Feb. 9, 1934 (Online by Gerhard Peters and John T. Woolley, The American Presidency Project, http://www.presidency.ucsb.edu/ws/?pid =14805).

2 J. Katz, *U.S. Securities and Exchange Commission: A Roadmap for Transformational Reform* 3, Center for Capital Markets Competitiveness (Dec. 2011).

. . . and regulators are understanding, speed is not always better. Nobody rational would look at this [market] and say it isn't broken."[3]

As a new Administration and Chairman set out to make their mark in the securities arena, it is time to consider whether the Commission is meeting its stated mission "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation"[4] at an expense to society that makes sense. The following thoughts are offered for consideration as the new Administration, the Congress and the Commission grapple with potential reforms relating to the administrative enforcement of federal securities laws.

Topical Versus Foundational Reform

The term "reform" in not a one-trick pony. Reform can address different levels and types of change when applied to an entity such as the Commission. On the one hand, reform can be topical, focusing on more granular issues that merit modification. On the other hand, it can be foundational, resulting in modification at the core of the entity's regulatory charge. The Commission is due both types of reform – some of which will require Congressional action and other of which will be within the grasp of the Commission to achieve on its own.

Illustrative Topical Reforms

With thanks to the likes of former Commissioner Paul Atkins'[5] and other Agency graduates' commentary identifying potential reforms that should be undertaken with respect to the Commission, it is clear that there are many topical issues that invite distraction. Case in point: Wholesale repeal of Dodd-Frank. Hope on, it's not going to happen. At best, over time, its major flaws (as well as flaws arising from other legislation) will be nibbled to death by ducks. Some targets for nibbling include:

- excluding mutual funds from Financial Stability Oversight Counsel Systemically Important Financial Institutions;
- avoiding having the Financial Stability Board's G-20 club of regulators drive capital market policy decisions;
- reversing the Commission's authority to require Uniform Fiduciary Standards for Investment Advisors and Broker Dealers;
- assuring that mutual fund investors can redeem their investments upon request;
- reversing the momentum for mutual funds to publish specific values rather than rounding net asset values;
- restraining the Commission from requiring funds and advisors with at least $10 billion in assets to conduct annual stress testing;

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3 D. Benoit, NYSE CEO: Knight Capital Another Reason for Reform, Wall St. Jour. Deal Jour. (Aug. 3, 2012) (http://blogs.wsj.com/deals /2012/08/03/nyse-ceo-knight- capital-another-reason-for-reform/).

4 https://www.sec.gov/Article/whatwedo.html.

5 Testimony of Paul S. Atkins before the U.S. House of Representatives Committee on Financial Services, *The Dodd-Frank Act Five Years Later: Are We More Stable?* (July 9, 2015); Remarks of Paul S. Atkins, 2015 Investment Advisor

- unwinding the ban on proprietary trading in commercial banks – the so- called Volker Rule (good luck!); and
- modifying the Sunshine Act to eliminate the unintended consequences it has had in inhibiting collegiality among Commissioners and reducing policy development by Commissioners (good luck will not be enough for this one).

Other topical reforms[6] – within the control of the Commission – could focus on the Commission's organizational inefficiencies (again, distractions), including:

- restraining prescriptive approaches to Commission management that etch in stone one way of doing things to the exclusion of others – for example, mandated direct reports to the Chair should be eliminated;
- elevating the economist function, including (*i*) having the economists report to the Commission, rather than to staff attorneys, and (*ii*) utilizing economists to decide whether or not to propose or adopt regulations after considering costs and benefits;
- transferring the staff of the Office of Compliance Inspections and Examinations to the Division of Trading and Markets/Investment Management in order to achieve synergistic oversight and regulation;
- properly incentivizing staff conduct by, among other things, focusing on quality management rather that stats-driving measurements; and
- neutralizing the increased politicization that has overtaken the Commission (fostered in part by Dodd-Frank party-line support).

More generally, the President is beating the drum of relief from regulatory overreach. The problem is that writing a rule to reverse an existing rule requires much of the same rigor as was required when the faulted rule was created. You cannot just erase the existing rule. Rather, the Agency must wade through some or all of the Sunshine Act, Administrative Procedure Act, Paperwork Reduction Act, Regulatory Flexibility Act, Small Business Regulatory Enforcement Fairness Act and politically contentious agendas among Agency members. But the SEC has an escape valve – surprisingly rarely used – under Section 36 of the Securities Exchange Act.

Section 36 extends to the Commission general exemptive authority "by rule, regulation, or *order*" (emphasis added) to relieve any "person, security, or transaction or any class or classes of persons, securities, or transactions" from any provision or rule or regulation "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." The Commission should breathe new life into that provision to bypass rules and regulations that are crushing small and medium size businesses and overwhelming the investing public

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Association Compliance Conference (Mar. 5, 2015); Statement of Paul S. Atkins at Hearing of the U.S. House of Representatives Committee on Financial Services, *Why FSOC Should Not Designate Mutual Funds as SIFIs* (May 20, 2014); P.S. Atkins, *Mistaken Ideas about Money-Market Funds,* AEI (July 18, 2012); Statement of Paul S. Atkins before the U.S. House of Representatives Committee on Financial Services on Fixing the Watchdog: Legislative Proposals to Improve and Enhance the SEC (Sept. 15, 2011).

6 *See* note 5 above.

with detail that it can neither absorb nor understand. And, because the Agency can do so by *order* rather than *rule*, the gauntlet that every rule must endure on its road to adoption largely evanesces.

Beyond such regulatory reform initiatives, the Commission should take a long, hard look at its Enforcement Division. The Division gained fame decades ago by successfully fighting fraud with a forward-looking prophylactic and remedial philosophy, bringing a halt to ongoing fraud and using the tools of equity to seek accountings, restitution and disgorgement from those who had stepped over the line. Those who stepped too far were referred to the Department of Justice for criminal prosecution. It was an awesome machine that successfully pursued the grandees of industry and finance – not broken windows or remote tippees. Today, that philosophy is reversed: Enforcement is retrospective, retributive and penal. The focus has become to get a big fine – the bigger, the better – to disgrace and permanently defrock the executive who made the mistake of bumping into a federal security statute, and then to impose the humility of an admission. While the objective should be to correct abuses and "safeguard values," it has become more akin to crushing the wrongdoer. There is not much "remedial" in that.

Finally, while no one would argue that the Enforcement Division should not have the authority to seek a reasonable display of documents to determine if violations of the securities laws have occurred, the Commission should be mindful of the high cost that fishing expeditions can impose on the fish. When sweeping subpoena after sweeping subpoena is issued against a company, the company must spend significant time and money to respond, often being forced to hire attorneys and electronic discovery experts. The cost of responding – particularly for a small- or mid-cap company – can be devastating. If the Commission cannot bring fairness to this process, Congress should consider legislation that would require that the Commission be required to conduct a full costs and benefits analysis prior to service or enforcement of subpoenas.

Foundational Reform

Sounds pretty good so far, right? Well, not entirely. While the Commission can make progress on these fronts, they are to some degree distractions from plumbing the depths of the foundational reform the Agency should be pursuing – that is, the fragmentation that has taken hold of the securities marketplace. Here, a bit of historical context will help.

Beginning in 1792 and continuing into modern day, shares were traded among Buttonwood/ exchange members based on fixed minimum commission rates adopted by the NYSE and exchanges across the country.[7] While brokers could charge more than the minimum rates, they could not charge less. After a 1963 Supreme 1963 decision, *Silver v. NYSE*, 373 U.S. 341 (1963), rejected the notion that the NYSE was exempt from the antitrust laws, the Department of Justice pressed the Commission to unfix those rates to promote competitiveness among brokers.

In response to Commission inquiries, the stock exchange establishment argued that fixed minimum rates were necessary to keep the securities industry profitable and could not be dropped quickly

7 *See The Great Unfixing*, ThinkAdvisor (May 1, 2010), www.thinkadvisor.com/ 2010/05/01/the-great-unfixing.

without significant market damage.[8] Despite this protest by the NYSE, the Commission began to chip away at fixed rates. In 1971, the Agency required that commissions be negotiated on transactions in excess of $500,000.[9] In 1972, the Commission lowered the transactional amount requiring negotiated commissions to $300,000. Finally – faced with potential Congressional action – the Commission ordered an end to fixed minimum commission rates effective May 1, 1975 – colloquially referred to as May Day or Mayday.[10] (Thank you, Gene Rotberg, the Commission's then-Associate Director of Trading and Markets.)

A related inflection point addresses the dynamics of trade execution. The exchange establishment was historically an auction market – with some exceptions, every trade had to be brought to the exchange floor for execution. Specialists (employed by member firms) were stationed at trading posts and acted as market makers to facilitate the trading of assigned stocks. By posting bid and ask prices, managing limit orders and executing trades, they provided liquidity, depth and continuity to the market, and stood ready to step in to buy or sell shares as necessary to ensure a fair and orderly market in particular securities. In 1986, there were approximately 420 specialists engaged in trading an average of approximately 250 million shares a day[11] – a specialist had its fingerprints on virtually every trade. More important, compliance with specialists' affirmative obligations to maintain orderly markets assured market structures were under their continuous surveillance.

A third inflection point is the quest for more competition in trading venues. Prior to May 2000, exchange establishment rules – like NYSE Rule 390 – required member brokerages to trade listed securities only on the exchange where they were listed. Large brokerages pressed for change so that they could trade directly with their customers and match orders without bringing them to the floor of the listing exchange.[12] The brash NASD advocated abolishing these trade restriction rules, arguing that brokerage firms should be free to determine the trading venue where they could achieve "best execution" for their clients.[13]

In the debate over whether to rescind these rules, those in favor argued that rescission would be a boost to competition that would lead to lower prices and tighter bid and ask spreads.[14] Those opposed argued that rescission would lead to market fragmentation which would in turn lead to inferior executions, inflated bid-ask spreads and price volatility. Such opposing commentators asserted that market fragmentation would raise issues regarding, among other things, the nature of the trading process, the development of the optimal order placement strategy, the impact of institutional arrangements on price formation and the continued role of the specialists in providing an orderly market.[15] Although the exchange establishment defended their rules – arguing, among other things,

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8 *Id.*

9 *In the Midst of Revolution: The SEC, 1973-1981 (Ending Fixed Commission Rates)*, www.sechistorical.org/museum/galleries/rev/rev02c.php.

10 *The Great Unfixing*, ThinkAdvisor (May 1, 2010), www.thinkadvisor.com/ 2010/05/01/the-great-unfixing.

11 M. Hiltzik, *End of an era: The NYSE Floor Isn't Even Good for PR Photos Anymore*, L.A. Times (Oct. 7, 2014).

12 T. S. Mulligan, *NYSE to Repeal Rule Forbidding Off-Floor Trades*, L.A. Times (Dec. 2, 1999).

13 *See NYSE Rulemaking: Order Approving Proposed Rule Change to Rescind Exchange Rule 390*, SEC Release No. 34-42758 (May 5, 2000).

14 T. S. Mulligan, *NYSE to Repeal Rule Forbidding Off-Floor Trades*, L.A. Times (Dec. 2, 1999).

15 *E.g.*, Bloch & Schwartz, *The Great Debate Over NYSE Rule 390*, The Journal of Portfolio Management 1978.5:5-8 (Fall 1978).

that the rules protected investors by bringing trades to the largest marketplace – the NYSE gave into the pressure and in December 1999 acquiesced to the Commission that Rule 390 be rescinded. The Commission approved the rescission in May 2000 – May having already been designated a bad month for the exchange establishment.

A fourth point of inflection is the explosion of trading venues resulting from technological advancements. While the rescission of the restrictive trading rules was focused on permitting trading to be dispersed across multiple traditional venues, new technological platforms – ECNs (electronic communications systems) and ATSs (alternative trading systems) – resulted in an explosion of completely new trading venues. This explosion led to increasing growth in the number of trading venues. Currently there are eleven exchanges and approximately 44 ATSs (including dark pools).[16] Approximately 78% of stock trades (including that of NYSE- and Nasdaq-listed shares) originate on ATSs. NYSE trading volumes in its listed securities dropped from 77% of volume (in 2005) to 32% (in 2015); Nasdaq trading volumes in its listed securities dropped from 53% (in 2005) to 29% (in 2014).[17]

In addition to electronic trading venues, electronic trading programs also have had a significant effect on market dynamics. The term algorithmic trading is often used to refer to automatic (or black box) trading systems that rely on a computer program to create a trading strategy heavily reliant on complex mathematical formulas and high speed computer trading programs – such as HFT (high frequency trading).[18] Such trading has led to "flash crashes" that result in a very rapid, deep and volatile fall in stock prices within an extremely short period of time from trades executed by black box HFT. There have been a number of notable flash crashes – including in May 2012, when a 1000 Dow low resulted from $4.1 billion in trading, and in April 2013, when $6.9 billion was wiped out on the Singapore Exchange.

The final inflection point is the Securities Act Amendments of 1975, which was passed in the same year in which May Day occurred. Passage of the Act was based on Congress' determination that the markets should be preserved and strengthened by the development of a National Market System. The goal was that the NMS, relying on new data processing and communication techniques to link all markets for "qualified securities," would create economically efficient mechanisms to provide for the best execution of securities transactions by providing increased transaction information that would enhance competition among participants in national markets. The Act directed the SEC to "facilitate" the establishment of the NMS in accordance with these Congressional objectives.

At the time Congress passed the 1975 Act, it had but a glimpse of the changes (in the form of elimination of fixed commission rates) that would impact the market over the next forty decades. The Act provides the Commission with broad authority to prohibit brokers and dealers from effecting certain transactions "otherwise than on a national securities exchange," but only if the Commission finds (on the record after notice and opportunity to be heard) that

16 Public Statement by Commissioner L. Aguilar, *U.S. Equity Market Structure: Making Our Markets Work Better for Investors* (May 11, 2015), www.sec.gov/news/statements/us-equity-market-structure.html.

17 J. Macey & D. Swensen, *The Cure for Stock-Market Fragmentation: More Exchanges*, WSJ, May 31, 2015.

18 Algorithmic Trading, www.investopedia.com/terms/a/algorithmictrading.asp.

- as a result of transactions in such securities effected otherwise than on a national securities exchange the fairness or orderliness of the markets for such securities has been affected in a manner contrary to the public interest or the protection of investors;
- no rule of any national securities exchange unreasonably impairs the ability of any dealer to solicit or effect transactions in such securities for his own account or unreasonably restricts competition among dealers in such securities or between dealers acting in the capacity of market makers who are specialists in such securities and such dealers who are not specialists in such securities; and
- the maintenance or restoration of fair and orderly markets in such, securities may not be assured through other lawful means.

A high hill to climb!

In 2005, the Commission stated that "[t]he [national market system] . . . incorporates two distinct types of competition – competition among individuals markets and competition among individual orders – that together contribute to efficient markets.[19]

The amalgamation of these various factors has resulted in significant market fragmentation. While former Chair Mary Jo White does not agree with former NYSE CEO Neiderauer's 2012 characterization of the market as broken (having asserted in a 2014 speech that the "current market structure in not fundamentally broken"), she has acknowledged that fragmentation in the market (particularly dark pools) has resulted in, among other things, a lack of transparency and accountability and a challenge to compliance efforts.[20]

As may be seen by this chronology of events from May 1975 until today, the Commission, rather than "facilitating" the development of fair and orderly markets, has facilitated chaos and entropy and has virtually abandoned the mandate of the Securities Act Amendments of 1975. It has sacrificed market oversight and compliance on the altar of competitiveness. The Commission has little grasp over market dynamics; it researches flash crash-type anomalies after the fact, but learns little about how to reform markets to erase the anomaly – other than feeble efforts such as circuit breakers to chill market frenzy.

The Commission must bring the private sector specialist affirmative obligation/oversight functions back to the marketplace and develop the tools to detect and prevent abusive trading strategies – even when those strategies contribute to "tightening the spreads." Competition and hyper-efficient electronic trade execution certainly have their role in the marketplace, but not at the expense of compromising market integrity.

Mr. Chairman, when facing topical versus foundational reform, keep your eye on the doughnut and not on the hole.

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19 SEC Release No. 51808 (June 9, 2005), 70 FR 37496, 37499 (June 29, 2005).

20 Speech by M. J. White, *Enhancing Our Equity Markets*, (June 5, 2014), www.sec.gov/News/Speech/Detail/Speech/1370542004312.