Testimony of
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Chairman Reed, Ranking Member Bunning and Members of the Subcommittee:

I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I would like to thank you for the opportunity to testify today.

I would also like to commend SEC Chairman Mary Schapiro and CFTC Chairman Gary Gensler for their leadership during the last two weeks. They swiftly engaged with exchange leaders and regulators and established a collaborative process to coordinate review of all relevant market data, as well as to identify measures that could be taken quickly to significantly reduce the chances of a recurrence of the severe market disruption that occurred on May 6.

There remains much more work to do, both in terms of diagnosing what led to the market drop May 6 and identifying additional proactive steps we may want to take to ensure that our markets are able to function more efficiently under highly volatile conditions. Ultimately, we all realize that the extreme market volatility two weeks ago underscored the need for regulators, and others operating in and around financial markets, to step back and recognize that with the immense changes in the market, there is a serious need to look at market structure, and identify a variety of measures that can enhance the information regulators receive to ensure market integrity and the protection of investors.

Efforts Undertaken Since May 6

Immediately after the market events on May 6, FINRA, in coordination with the SEC and other self-regulatory organizations (SROs), began the process of trying to identify unusual activity that could have contributed to the rapid market drop. Even before the market data had been fully collected, FINRA staff reviewed clearly erroneous trade filings and, along with NYSE Regulation, interviewed the approximately 20 firms with significant activity during the period of the decline. Along with NYSE Regulation, we contacted the firms to determine whether “fat finger” or other trading errors occurred, either as a result of proprietary or customer activity. None of the firms contacted identified any trading errors or other unusual activity on their part, nor has any firm come forward since, nor has any evidence been developed to indicate that a single large trade or basket of trades entered in error played a role in the market decline.

On May 7, we contacted over 250 firms to determine the impact of the market disruption to the firms and their customers. Our inquiries covered a range of issues depending on the type of firm, including funding and liquidity, customer exposure, increased margin calls, net capital implications and how firms intended to reestablish limit orders that were executed and then cancelled. We followed up with particular firms last week to ensure that appropriate steps had been taken to address any issues identified in our initial discussions. While firms cited a number of operational and other issues, none appeared to be systemic in nature. In addition, we are examining the flow of customer complaints to both us and the firms concerning order handling and execution practices during the market decline.

We have focused our review of the vast amounts of trading data on the approximately 300 stocks that experienced the most dramatic decline during the 30-minute period in question. That list, unsurprisingly, coincides with the list of securities that were the subject of cancellations and reversals by the markets on the evening of May 6. We continue to review order entry and trade reporting data for the 300-plus stocks, and have identified a subset of these stocks for further inquiry, based on an analysis of a concentration of order and trade activity in the period immediately prior to and during the market drop. Focusing on the selling activity in these securities (some of which, incidentally, are exchange-traded funds), we, again working closely with both SEC staff and staff from the other markets, contacted those firms that were most active. Our lines of inquiry, while quite broad, include an analysis of short selling during the period and the role that algorithms played, including the specific strategies and triggers employed by the trading firms. Finally, we are talking to the largest broker-dealer alternative trading systems to determine whether they had system issues that may have contributed to the market drop.

While there is still much to be done before we can say that we have definitively pinpointed the cause or causes of the decline, I think we can say that certain basic truths have emerged, and that we should not wait to adapt to them. First, we know that the process for restoring order following an event like last Thursday should be more transparent and predictable.

Second, this event demonstrated that the conventional wisdom that the futures markets tend to move first continues to hold, as does the notion that the market is highly efficient in shifting that momentum from the derivatives side to the cash side, creating fast and focused selling pressure across wide numbers of stocks and ETFs. That point, that the equities markets can find themselves dramatically influenced by external market movements, now has a clear corollary completely self-contained in the equities space.

Specifically, as we've seen exchange barriers to entry drop, competition rise and market structure policy compel connectivity among exchanges and between exchanges and other execution venues, we see that market quality can no longer be ensured by a single exchange acting in a siloed fashion. Moreover, while the market fragmentation that has occurred has lowered barriers to entry and created fierce competition resulting in narrow quotation spreads and a high level of liquidity in good times, it also results in the fact electronic removal of liquidity when markets are stressed. It also generally resulted in the elimination, in many cases, of meaningful market maker obligations while retaining residual regulatory requirements for two-sided quotes that has led to the "stub quoting" phenomenon that contributed to the extreme price volatility. In short, while our equity market structure performs well under normal conditions, change is urgently needed to better address these flash market break situations.

Taking note of that last point, FINRA was pleased to have participated in a series of discussions with the U.S. equities and options exchanges, at the direction of the SEC, to establish a framework for market-wide, stock-by-stock circuit-breaker rules and protocols. The result of this coordinated effort are the rule changes filed on Tuesday by each of the exchanges and FINRA to implement the following stock-by-stock circuit-breaker protocols on a pilot basis for all securities included in the S&P 500:

- If the price of a security changes by 10 percent within a rolling five-minute period, trading in that security will be halted for five minutes.
- A message will be sent simultaneously to all the markets and FINRA.
- The primary market for the security will employ its standard auction process to determine the opening print after the five-minute halt period.
- The authority will apply from 9:45 a.m. to 3:35 p.m., Eastern Time.

This solution will allow a pause in trading that will allow market participants to better evaluate the trading that has occurred to correct any erroneous “fat finger” orders and to allow a more transparent, organized opportunity to offset the order imbalances that have caused the volatility. In this way, this regulatory response should reduce the negative impacts of sudden, unanticipated and otherwise unexplained dramatic price movements in individual securities. This is far preferable to the markets having to be in the position of going back after the fact to determine what trades should be broken when markets go close to zero.

Additional implementation and technological issues will be discussed and resolved by the relevant markets in the coming weeks, with the goal of implementing the new circuit-breaker authority within 30 days after Commission approval. Once implemented, the markets and FINRA will be monitoring continuously the application and effectiveness of the rule’s framework and protocols to determine the most efficient and effective permanent approach, in anticipation of such authority being expanded to a broader range of securities.

Next Steps

As we look past these shorter term steps to address what we saw in the market two weeks ago, longer term concerns must also be addressed if we are to reassure market participants, including retail investors, that our equities markets are stable and fair. And this is true irrespective of whether these issues played a major contributing role in the specifics of the decline on May 6.

First, firms need to ensure that they do not continuously feed in orders once markets have broken with respect to precipitous declines.

Second, firms must properly supervise customers to whom they have given "direct access" to the markets, thereby allowing a customer to trade on an exchange using the firm's market participant identification code. Any firm that provides its name to and/or sponsors a transaction has a responsibility to ensure the proper reviews for those transactions are in place.

Third, there should be a continued analysis of various markets' rules regarding circuit breakers and clearly erroneous trades, with an eye toward consistency and transparency of these rules across markets. As Chairman Schapiro has said, "the primary objective should be a market structure that minimizes to the greatest extent possible any need to correct erroneous trades. When necessary, however, the process should be applied in a consistent manner under established rules that are fair to investors." I also agree with Chairman Schapiro that the practice of displaying stub quotes should be analyzed and potentially eliminated.

Finally, and most broadly, the events of May 6 demonstrate the vital importance of the SEC's current review of market structure, rule proposals on direct market access and large trader reporting, and the forthcoming proposal related to establishing a consolidated audit trail.

Market Structure Review and the Need for a Consolidated Audit Trail

The sometimes dizzying speed of change in the markets, which puts a premium on innovation and competition, has made it imperative that regulators act now to close regulatory gaps that ineffectively discourage illicit activity in the shadows. The lag between market innovation and regulation is particularly pronounced in the increasingly fragmented area of equity trading. There, we have seen a rapid evolution of how and where trading occurs, and how quickly—and transparently—it is executed. High-frequency trading, dark pools and direct access are now commonplace, compelling regulators to adapt to ensure that market participants play by the rules.

A generation ago, the vast majority of activity occurred on the equity market that listed the security. Today, orders are routed to some 50 competing platforms. This complex environment creates opportunities for traders seeking unfair advantage to manipulate markets. How? By exploiting inconsistencies or gaps created when the responsibility of regulatory oversight is divided. Regulatory gaps and splintered oversight make it possible for trading abuses—such as market manipulation, marking the close and front-running customer orders—to be carried out furtively across multiple markets, with a reduced chance of detection.

By spreading trading activity across different market centers, firms can attempt to disguise abusive trading activity by exploiting the existing gaps in audit trail data. Although regulatory authorities currently examine for, investigate and prosecute abusive trading activity when it violates existing regulatory obligations, we are hampered by the lack of a comprehensive, sufficiently granular and robust consolidated audit trail across the equity markets. The most effective way to surveil for these trading practices across the wide range of market centers is to consolidate audit trail data in a single place so that violative trading practices can be more readily identified.

Each market is required to have in place rules that, among other things, seek to prevent fraudulent and manipulative acts and practices, and protect investors and the public interest. Although each market is responsible for regulating and surveilling the trading conducted on its market, as markets become increasingly fragmented and securities trade on multiple venues, regulation of activity that crosses markets becomes a vital component of ensuring overall market integrity and maintaining investor confidence. This is particularly so because trading abuses such as insider trading, market manipulation, marking the close and trading ahead of customer orders so easily can be conducted across multiple markets. FINRA believes that a consolidated audit trail across markets, and eventually across investment products, is essential to ensure comprehensive surveillance of the equity markets and related markets so that abusive trading activity can be detected in a more timely, efficient and comprehensive manner.

Today, regulation of the equity markets is split among FINRA and other SROs, and no single regulator has a full picture of all trading activity in the U.S. equity markets, either on a product-specific, firm-specific or, under certain circumstances, even an order-specific basis.

The announcement on May 4 that FINRA will assume market regulation for NYSE Euronext's U.S. platforms is a major step toward establishing such a unified approach to market oversight. Under the plan, FINRA—which already conducts market surveillance for the NASDAQ Stock Market and trading occurring off-exchange—will be responsible for aggregating and regulating approximately 80 percent of trades in equities made at U.S. market centers. The benefits for market integrity and investor protection are profound. But perhaps more importantly, empowering a single set of eyes to oversee the majority of transactions will facilitate the necessary progress toward a truly holistic approach to regulation that addresses the realities of today's marketplace.

Quite simply, technological advances in trading systems, coupled with market fragmentation, have led to a situation where comprehensive intermarket surveillance is essential to ensuring the overall integrity of the equity markets. Moreover, the major hurdles of just a few years ago to consolidated market surveillance have been significantly reduced due to the progression of market structure and the convergence of many aspects of exchanges' business models. With the changes to market structure resulting from Regulation NMS and virtually all aspects of trading becoming electronic, the previous distinctions between market types are quickly fading away, minimizing many of the prior obstacles to consolidated audit trail data and oversight.

Since the adoption of Regulation NMS in 2005, there has been a significant increase in market linkages, the result of which is that trading activity that originates on one market often has a profound effect on other markets. This, of course, creates a much greater possibility of cross-exchange market manipulation where, for example, trading on one market is used to artificially affect a security's price and trading on another market is used to take advantage of that price change. A similar problem exists when surveilling for compliance with rules that prohibit firms from trading ahead of a customer order, such as limit order protection rules and front running rules. In these cases, the proprietary trading may be executed on one market while the customer trade is executed on another. These problems are exacerbated by the fact that some firms trade using multiple market participant identifiers (MPIDs) or trade pursuant to market access arrangements whereby the firm's trading is identified with an MPID assigned to a different firm.

FINRA believes there should be consistent and uniform gathering of order, trade and quote information across all equity and options markets, and that the audit trail must be sufficiently granular to enable regulators to readily identify trading activity by market participants across markets. A consolidated audit trail would not eliminate all the challenges of analyzing the data from a 66 million trade day like May 6, but it would make the process significantly more efficient and effective.

We look forward to working with the SEC, and with this Committee, as we continue our work on these important initiatives that lie at the heart of enhancing regulators' ability to best oversee today's markets.

Conclusion

We will continue to work with our fellow regulators to diagnose and identify corrective measures to address the significant market disruption two weeks ago. The SEC and CFTC spearheaded a process that has resulted in a coordinated, market-wide proposal that will quickly and dramatically lessen the chances for an event like that we saw May 6. But the effort is far from over.

Further analysis of rule changes, highlighted by both the market drop and the SEC's current market structure review, can and will strengthen our system to further ensure that rules and regulators are best positioned to ensure the continued integrity of U.S markets and to protect all investors who participate in those markets.

Again, I appreciate the opportunity to share our views. I would be happy to answer any questions you may have.