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Statement of

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Chairman
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for the

Subcommittee on Securities, Insurance, and Investment
Committee on Banking, Housing, and Urban Affairs
United States Senate

Hearing on

Dark Pools, Flash Orders, High Frequency Trading, and Other Market Structure Issues

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Chairman Reed, Ranking Member Bunning, and members of the subcommittee, thank you for the opportunity to testify at this important hearing on behalf of the Security Traders Association.

I am Peter J. Driscoll, a Vice President and Senior Equity Trader at the Northern Trust Company, Inc. in Chicago, Illinois and the Chairman of the Security Traders Association (STA). I am here today representing the STA, a professional trade group that provides a forum for our traders, representing institutions, broker-dealers, ECNs, exchanges, market makers and floor brokers to share their unique perspective on issues facing the securities markets. Our members work together to promote investor protection and efficient, liquid markets.

The financial services industry robustly competes for order flows today. Individual investors trade in markets that are characterized by narrow bid ask spreads, historically low commissions, immediate electronic execution of trades, and research provided without charge.

It is important, however, to realize that the vast majority of savings and investments are institutionalized, invested through savings plans at work, 401ks, pension plans, or mutual funds. Professional money management and diversification is critical for most investors who have neither the time and training or the resources to manage their own money. The institutions that work to identify investments for these funds are in reality representing the individual investors and working on their behalf. The aggregation of the interests of retail and institutional investors brings its own challenges. Like retail investors, institutional investors also value low commissions, tight bid ask spreads and competition for their order flow. The size of these aggregated orders also focuses their efforts on identifying pools of liquidity, be they exchanges or other trading venues that provide deep liquid markets where they can secure the best possible execution of these large orders on behalf of their shareholders.

The U.S. equity markets functioned extremely well during our recent economic crisis. The markets remained open, collectively trading billions of shares daily and priced equity securities efficiently according to the economic laws of supply and demand despite the dramatic financial news that was impacting the nation. Throughout the declining markets, security prices were accurate and represented the equilibrium between buyers and sellers at the moment of execution. As most are aware there are times when there were more sellers than buyers and prices decline significantly. Though painful, this is a natural operation of the markets and our equity markets functioned exactly how they were designed to function. Because of this, our markets have been referred to as a national jewel and the envy of the world and they lived up to that billing every single day during the economic upheaval.

We commend the subcommittee for taking a proactive approach to being an informed overseer of the markets. Your scrutiny is welcome and this debate is a healthy one. Open forums such as this are an important part of the regulatory process. Unfortunately, the topics before us today are technically complex and not well understood outside the industry itself. Additionally, the industry's flair for the dramatic has given these rather mundane mechanisms names like dark pools that carry a negative connotation. The market practices that we are examining today are not new; they have merely been transformed to be effective in the ever evolving electronic market structure. At the Security Traders Association, we characterize this evolution as natural growing pains that require industry debate to determine if regulatory attention is needed. It is my pleasure to be here on behalf of the STA, to be part of the informed debate by industry participants who understand trading processes and the potential ramifications any proposed regulations may have on our markets.

The Securities and Exchange Commission (SEC or Commission) announced that they will issue a concept release concentrating on the topics that we are addressing here today. The Commission also held an open meeting where they voted unanimously to issue proposals intended to strengthen regulation of dark pools of liquidity. These proposed rules were issued in the regular notice and comment rulemaking process affording all market participants the opportunity to comment on the rules and discuss their concerns about their effect on the markets. The STA feels that this process is the best way to uncover any unintended consequences that a proposed rule may have prior to it causing any serious disruption to the market.

Targeted regulation that ensures technology is used appropriately and that all participants have equal access to market data and trade execution is a mandate of the regulators. Identifying manipulation is the appropriate priority of regulators. The Congressional Oversight panel in their January Special Report on Regulatory Reform said:

> The essential debate… [is a debate] between wise regulation and counterproductive regulation. "Wise regulation helps make markets more competitive and transparent, empowers consumers with effective disclosure to make rational decisions, effectively polices markets for force and fraud, and reduces systemic risk. Counterproductive regulation hampers competitive markets, creates moral hazard, stifles innovation, and diminishes the role of personal responsibility in our economy. It is also procyclical, passes on greater costs than benefits to consumers, and needlessly restricts personal freedom."

We believe that there is room for wise regulation targeted to the areas currently under review.

Dark or undisclosed liquidity has been part of the markets since their inception. In fact, many believe that the New York Stock Exchange was one of the largest dark pools in the markets. Floor brokers working large orders traditionally posted only small portions of the order in publicly displayed quotes. Dark liquidity is nothing new, though its use has grown.

Like dark liquidity, market making has always played a role in the equity markets. The participation of market makers has historically helped promote efficient pricing as they make orderly two-sided markets, stepping in to buy or sell a security when other market participants were unwilling to do so.

Concerns have arisen about how these two functions fit in the new electronic markets. Dark pools and electronic market making have largely replaced the old manual processes and have increased in popularity for several reasons. Decimalization of the markets in 2000 reduced the risk/reward scenario for market makers by reducing the potential spread capture, the traditional means for market maker remuneration, from 6.25 cents to a penny. They retained all of their obligations to the market, including providing continuous two sided markets and being the liquidity of last resort, but the rewards for these obligations were cut dramatically. Traditional market making became unprofitable and most market making firms reduced their market making activity or bowed out of the business altogether. For the institutions, decimalization meant smaller trade increments and institutions had to change the way they worked orders in the market. Anonymity is essential to prevent market players from capitalizing on the information about their large institutional orders.

Alternative Trading Systems

Private trading facilities began to attract institutional order flow and prosper because they provided the anonymity institutional traders desired and reduced the likelihood of information leakage. These new trading venues provided the institutions with a means of executing their orders without impacting the price of the stock significantly in this penny pricing environment. Private trading facilities would match orders within their systems using the current public quote to price the matches while depriving other market participants the opportunity to step ahead of their orders.

These private trading facilities are subject to Regulation Alternative Trading System (ATS), promulgated by the SEC to foster competition among exchanges and other liquidity pools. The rule has been tremendously successful in incubating new technology and fostering technological competition for the exchanges. Regulation ATS provides a registration and regulation regime for upstart businesses to enter the markets and compete with minimal regulatory hurdles.

While Regulation ATS has gone further than any other regulation in fulfilling a Congressional goal of the Securities Act Amendments of 1975 by making it practical for "investor's orders to be executed without the participation of a dealer," restricting access to certain dark pools and limiting reporting of quotes and transactional data appears to run contrary to another Congressional goal of those amendments. Namely, that "linking of all markets for qualified securities … will foster efficiency, enhance competition, increase information available to brokers, dealers and investors… and contribute to best execution of such orders." As such, the STA believes that it is appropriate for the Commission to evaluate dark pool access and transparency standards.

Trading and the pursuit of "best execution" involves strategy and the use of dark liquidity is one tactic in that strategy. Working an order in the dark allows the buy side trader to keep control of the order, keep the trading strategy confidential and limit the number of shares exposed to the price discovery process at one time. Limiting the size of the order exposed to the price discovery process allows the trader to avoid overwhelming the supply/demand equilibrium and thus achieve better priced executions. A great majority of market professionals believe that dark pools, or alternative liquidity pools as the STA generally refers to them, increase efficiency by lowering execution costs and providing competitive choices in the execution process.

Some market participants believe that trading in dark pools degrades the price discovery process, the results of which alternative liquidity providers use to price orders. Traditionally, the large institutional orders have not been the driver of the price discovery process. It has been the small orders, fragments of the larger orders that interact to find the equilibrium price. While we understand the price discovery concerns and believe that at some point degradation may occur, we do not feel that with dark volumes trending around 10-15% of overall volume we are anywhere near that degradation point. As with most things in life moderation is a key. An efficient market structure can include alternative liquidity pools and public quoting venues coexisting. As long as we keep the appropriate level of order flow pumping through the price discovery process we should not see negative effects from this coexistence. In fact, recent statistics indicate that the overall level of alternative liquidity use has plateaued and individual pool gains now come at the expense of other alternative liquidity pools. In our 2008 Special Report we suggest that the Commission "should closely monitor the aggregate and individual volumes of alternative liquidity pools in order to ensure adequate price discovery." We stand by that recommendation today.

It has been suggested that trading in alternative liquidity venues disadvantages the ordinary retail investor. This is simply not factual. As we mentioned earlier the "average investor" invests through organized investment plans. These institutions use alternative liquidity providers to increase the efficiency with which portfolio decisions are implemented and reduce the costs associated with that implementation. If you consider the average retail investor who has a discount brokerage account and executes trades daily we would continue to point out that alternative pools of liquidity provide benefits to those participants. Prior to the advent of electronic trading and alternative liquidity pools small investors were concerned about trade certainty. Orders took several minutes to execute and the investor was at risk during those minutes. Electronic markets provide instanteous executions, dark pools have provided the retail investor with the opportunity for price improvement as their orders flow through these alternative pools and the participation of high frequency traders assures that the size desired by the investor will be present when an execution consummates.

Assuring fair access to these alternative pools of liquidity and increasing their transparency are important goals. As individual dark pools gain market share and their volumes grow it will be important to allow other market participants to not only see the order flow through the quotes required once threshold levels have been achieved but also interact with that order flow. The STA does not believe that limiting the successful dark pools to de minimis percentages of volume is the appropriate answer. Regulation NMS was promulgated to promote the public display of limit orders, it drove more trading to dark venues. Trimming the quoting and access thresholds to unrealistically low levels could result in an explosion of new ATSs and further fragment the market. Once a pool sponsor has developed the logic for the dark pools matching engine, it may easily replicate it under a separate ATS filing. Structural speed bumps will not force the dark pool operators to push order flow to lit venues. There needs to be an incentive for order senders to prefer the lit venues over the alternative venues. Should the SEC through empirical evidence determine that too much volume is trading in dark pools or that there are too many dark pools, the standards that ATSs must adhere to should be upgraded and competitive pressures should be allowed to solve the problem. Increasing access and transparency is the answer, not arbitrarily limiting the amount of business that can be done by one alternate liquidity provider.

Dark pools should not be allowed to selectively share trading information. Once a pool decides to share information beyond what they provide to their members that information should be publicly distributed. This transparency must be increased without jeopardizing the pool participant's anonymity. Our members believe that a consistent reporting regime must be developed so that participants can make informed routing decisions. We further believe that pool operators must provide participants with detailed information about how their routing decisions are made and where the orders entrusted to them are executed. The STA also believes that post-trade transparency must be upgraded in such a way to allow other market participants to see which pools are attracting flows in which issues while preserving the anonymity of pool participants.

The STA has long held that similar products should be regulated by consistent rules. We understand that exchanges receive some benefits that ATSs do not. We are also aware that ATSs benefit from the displayed quotes produced by the exchanges. We do not believe that the offsetting of these benefits is disproportional enough to support the degree of regulatory bias favoring one market structure over the other. ATSs have changed the trading landscape. We believe that while it is always important to incent competitive behavior, the regulatory gap between ATS regulation and exchange regulation should be rationalized. Balancing the regulations will allow all venues to compete more robustly.

High Frequency Trading

The term "high frequency trading" is used to reference many different business models. For example, statistical arbitrage firms search for price disparities in the relationship between securities. They purchase the theoretically cheaper security and sell the more expensive one hoping to profit when prices regress to the mean. This type of arbitrage helps make markets more efficient and dampens volatility. Other high frequency traders hold themselves out as the new market makers. Market makers, as mentioned before, have traditionally had significant obligations to the markets and generally position risk for longer than milliseconds. Some question if market making is needed in the high volume millisecond trading environment that exists for primary tier stocks. We believe that there is a need for market making in secondary and tertiary issues, but not necessarily the primary tier stocks where data suggests most high frequency traders concentrate their activity. As competition enters the high frequency market making arena we would expect that trading profits would constrict forcing these market makers to begin making markets in lower tier stocks. Our members believe that high frequency traders provide liquidity and that their trading volumes help keep exchange fees low.

In the Special Report, "The STA's Perspective on U.S. Market Structure" that the STA issued in May of 2008 we expressed concerns about businesses being built solely to capture rebates from maker/taker models and market data plans. We remain concerned about the distortive effects these businesses could have on issues by generating quotes and trades without investment intent contributing to the flickering quote problem. STA suggested that the SEC adjust market data revenue allocation formulas to only reward "quality and tradable quotes and to discourage quotes that serve only commercial interests…" We believe this remains good advice and look forward to working with the Commission to bring it about.

Sponsored Access

Sponsored access, the ability of an exchange member to provide access to a customer, must include appropriate trade risk management controls. Allowing "naked" sponsored access in today's interconnected markets is undesirable from both the industry and regulatory perspectives. One minor mistake in order entry could become a major problem across many different trading venues if trades are allowed to bypass risk management tools. Problems of this nature would put at risk many market participants and not just the participant who created the problem.

Co-Location

Co-location is arrangement where a market participant can locate their server in the same location that houses the trading venue's matching engine. There is nothing inherently unfair in co-location as long as access is provided to all who desire it at a reasonable cost. Last week two major trading venues voluntarily accepted Commission oversight of their co-location plans. We feel that this is an extremely positive advancement in the regulation of co-location and that the Commission should monitor changes in these plans to ensure a level playing field.

Regulatory Resources

To adequately monitor and regulate the many issues we have discussed, we believe that the SEC needs the resources to upgrade their technology and hire more people to survail today's highly complex markets. Trying to monitor 35,000 registered entities with only 3,000 plus or minus staff members seems a daunting task. The already knowledgeable staff could also be bolstered through the addition of staff who are seasoned market professionals.

Conclusion

The Security Traders Association looks forward to working with market participants, governmental and self regulators and the Congress on these technical market issues that have grown to be of national economic importance. We underscore the importance that any changes to the current regulatory framework need to be done in a deliberate and carefully considered manner, and if rules are adopted, to use pilot programs whenever possible to ensure against the possibility of market disruptions. We also emphasize the need for the SEC and the Congress to avoid "picking winners and losers" and to allow competition and innovation to drive market changes whenever possible. Regulation should not protect inefficiencies that must ultimately be paid for by investors.

That concludes my remarks on behalf of the Security Traders Association. I thank you for the opportunity to participate in this important hearing today.

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The Security Traders Association

What We Are

Founded 75 years ago, the STA is an association of some 5,200 individual professional traders of equities and options, represented in and by 26 affiliates across North America. Our members represent all segments of the industry - the buy side, the sell side, exchanges, ECNs and ATSs. They trade on behalf of investors of all types: individual, institutional and professional.

Over the years, STA has contributed significantly and expertly to the legislative and regulatory discussion around market structure issues. Because our membership is drawn from all segments of the industry, the consensus views we develop, through our committee process, often render the best "pre-vetted" market structure solutions for investors, issuers, the industry, and our members. Our Committees provide a voice for: the sell side (Trading Issues Committee); the buy side (Institutional Committee); options traders (Options Committee); and compliance officers (Compliance Committee). Positions are recommended and voted on, and are then reviewed and approved by our Board of Governors.

We have issued eight position letters in 2009. In addition, we have produced two important White Papers: "Fulfilling the Promise of the National Market System – STA's Perspective on U.S. Market Structure" (2003); and "The STA Special Report – U.S. Market Structure 2008" (2008).

What We Believe

The U.S. equity markets have demonstrated the "modernization and strengthening" intended with the SEC's implementation of Regulation NMS in 2007. The National Market System is always an evolving "work in progress." As in the past, the current market structure issues are a result of explosive growth due primarily through technological and regulatory changes. Examination of today's issues is not only important, but also is appropriate and healthy.

We believe that a balance of competition and regulation yields superior results for all investors, issuers, markets, and the industry. We support the SEC as the appropriate regulator for our markets. In such a highly technical environment, the SEC has the understanding and procedures in place allowing for efficient regulation, consistent with goals mandated in the Securities Act Amendments of 1975. We encourage a pragmatic approach to ensure appropriate outcomes, based on empirical evidence and domain expertise.

Given the role of the SEC, we strongly support the maintenance of the Concept Release and notice and comment process as a critical component of effective rule making by allowing all interested parties to submit their views. This process allows a broad review by the SEC prior to issuance of a final rule. Escaping the "unintended" is a major benefit.

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