BARNEY FRANK, MA, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

SPENCER BACHUS, AL, RANKING MEMBER

August 24, 2010

The Honorable Mary L. Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Dear Chairman Schapiro:

As credit markets deteriorated throughout 2008, U.S. equity and options markets functioned exceptionally well. Even though order traffic, volume and volatility spiked in September and October of 2008, all investors were able to efficiently purchase and sell equities and options. The significant technology investments made by exchanges, alternative trading venues, broker-dealers and market information vendors paid dividends during this turbulent period, by creating a more stable trading environment and preventing investor panics. Unfortunately, these equity and option market successes are the untold story of the financial crisis.

The U.S. capital markets remain efficient, liquid, transparent and accessible to all investors. In fact, since 2000, numerous advances in equity and options market structure have helped to ensure that the U.S. maintained its preeminent position among world markets. Yet the technological progress that benefitted all investors during the financial crisis is now being called into question as a result of the May 6 market events.

As neither the Securities and Exchange Commission (SEC) nor the Commodity Futures Trading Commission (CFTC) have been able to precisely explain the May 6 trading activity, regulators and policymakers alike should exercise caution when labeling the events of that day as the "flash crash," as it presumes that so-called flash orders were the culprit. Before assigning blame to algorithmic or "high-frequency trading" firms, the SEC should seek to understand the importance of liquidity providers that now operate in our markets as a direct result of the adoption of Regulation NMS in 2005. Changes in equity market structure did not occur overnight and the SEC's response to these changes should be based on economic and empirical market data, not political pressure.

Earlier this year, the Commission issued a concept release seeking comments on the structure of equity markets. The concept release should have served as a comprehensive blueprint for future market structure. However, since that time, the SEC has, on a seemingly *ad hoc* basis, proposed a number of rulemakings on various issues covered by the concept release.

The SEC already has significant responsibilities, which will only grow with the enactment and implementation of the Dodd-Frank Act. While many commentators focus on the Commission's investor protection mandate, the National Securities Market Improvement Act of 1996 mandates that the SEC promote "efficiency, competition, and capital formation." We have a number of questions relating to whether and how the SEC's recent proposed rulemakings consistently fulfill both of these mandates.

1. Does the Commission believe that equity and options markets functioned well during the financial crisis in 2008-2009?

2. During the height of the financial crisis in the fall of 2008, please describe how investors of all kinds – small, large, professional, retail, sophisticated and unsophisticated - were disadvantaged, if at all, by recent market innovations.

3. If one of the Commission's mandates is to promote competition, how will investors benefit from eliminating the ability of broker-dealers, exchanges, and trading systems to compete for order flow by banning execution methods?

4. Please describe the economic analysis that the Commission used to determine that the equity markets would be better served by the elimination of so-called "flash orders."

5. Has the SEC conducted any analysis of how the elimination of flash orders is likely to affect price transparency, liquidity, and execution quality currently enjoyed by retail customers? If so, what were the Commission's findings?

6. What are the benefits of algorithmic or "high-frequency" trading? Does high frequency trading contribute to the narrowing of spreads? Do retail investors, more and more frequently represented by pension funds, ultimately benefit from the presence of high frequency traders?

7. Has the SEC performed an economic analysis to determine how costly and burdensome it will be for companies to implement Consolidated Audit Trails and the Large Trader Reporting proposal? How did the Commission eliminate duplication in these initiatives?

8. Has the SEC considered the impact these recent proposals will have on market liquidity?

9. If the Commission decides to impose certain market maker obligations for the use of "stub quotes," what benefits will the Commission also consider to ensure that economic incentives remain for such providers of liquidity?

10. How often does Commission staff, outside of the formal examination process, visit with exchanges, traders, liquidity providers and information vendors to more fully understand their role in the capital markets to better inform the Commission's examinations and rulemakings?

11. While developing a consolidated audit trail is a large undertaking and the scope of such a system may need to be modified to address certain concerns, it should be a high priority for the Commission. What is the Commission's expected timeframe to move forward on a consolidated audit trail? What are the expected costs to implement it?

12. The Large Trader Reporting proposal appears to overlap or duplicate some of the purposes of a consolidated audit trail. Would it be more efficient to consider both the large trader report proposal and the consolidated audit trail proposal in conjunction with each other?

13. While the Commission is working to meet the deadlines imposed by the Dodd-Frank Act, the Commission should prioritize the completion of important rules relating to the May 6, 2010, market events such as the circuit breakers and clearly erroneous trade rules. These rules are important to provide uniformity in times of unusual or volatile activity in certain stocks. When does the Commission intend to finalize clearly erroneous and circuit breaker rules? Should the SEC consider limit up / limit down trading curbs as opposed to circuit breakers?

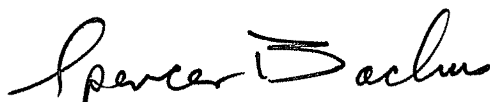
14. Capital formation is the primary function of the marketplace. While competition has fostered innovation in the US equity markets, our modern market structure must emphasize the importance of capital formation and the markets' ability to allocate it efficiently. Smaller capitalized companies' access to capital may need more incubation time and indeed even greater policy considerations than larger cap companies. Has the SEC considered the unique needs of smaller capitalized companies in the marketplace in promulgating its market structure regulations?

15. The Dodd-Frank Act makes changes to how the SEC is funded and nearly doubles the authorized appropriations to the SEC by fiscal year 2015. If Congress ultimately decides to double the funding for the SEC to $2.25 billion by fiscal year 2015, please describe how the Commission would use the increased funding.

While simple markets may be easier to regulate, they may not necessarily serve the best interests of all investors. All investors – large and small, professional and retail – have benefitted from the additional liquidity introduced by innovative market functions. Turning back the clock and reversing the innovation and progress that the equity markets have enjoyed in recent years could do more harm than good and may damage our global reputation. Rather than prohibiting practices that have a positive market function, it is our hope that the SEC will seek to better understand the market and become a more sophisticated and thoughtful regulator that fully considers the entirety of its Congressional mandate.

The ultimate success of our capital markets will, in part, rely on a regulatory structure that promotes competition and innovation. Please respond to us in writing by September 10, 2010. We look forward to working with the Commission on these important issues.

Sincerely,



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