

Opening Statement of Senator Carl Levin (D-Mich.)

Before

Subcommittee on Securities, Insurance and Investment and Permanent Subcommittee on Investigations

At a Joint Hearing On

Examining the Efficiency, Stability, and Integrity of the U.S. Capital Markets

December 8, 2010

Today, U.S. capital markets, which traditionally have been the envy of the world, are fractured, vulnerable to system failures and trading abuses, and are operating with oversight blindspots. The very markets we rely on to jump start our economy and invest in America's future are susceptible to market dysfunctions that jeopardize investor confidence.

I would like to thank Chairman Jack Reed, his ranking Member Senator Bunning, and all our colleagues from the Securities, Insurance, and Investment Subcommittee who have already held hearings on these issues and welcomed our Subcommittee to join with them today to shine a light on problems that threaten U.S. market stability and integrity.

Fractured Markets. The first fact we need to grapple with is that our markets have changed enormously in the last five years. In the past, most U.S. listed stocks were traded on the New York Stock Exchange or the Nasdaq. Seven years ago, the New York Stock Exchange alone accounted for about 80% of the trades in its listed stocks. But today, less than 25% of the New York Stock Exchange listed stocks are traded there. What happened? Stock trading now takes place, not on one or two, but 13 stock exchanges.

This chart, Exhibit 1, shows how the U.S. stock market has fractured. Stock trading now takes place on 13 exchanges as well as multiple off-exchange trading venues, including 3 Electronic Communication Networks, 36 so-called "dark pools," and over 200 registered "broker-dealer internalizers."

Electronic Communication Networks or ECNs are computerized networks that enable their participants to post public quotes to buy or sell stock without going through a formal exchange. Dark pools, by contrast, are electronic networks that are closed to the public and allow pool members to buy and sell stock without fully disclosing to each other either their identities or the details of their prospective trades. A broker-dealer internalizer is a system set up by a regulated broker-dealer to execute trades with or among its own clients without sending those trades outside of the firm. These off-exchange venues are increasing their trading volumes,

most use high speed electronic trading, and they escape much of the regulation that applies to formal stock exchanges.

These new trading venues didn't appear out of thin air. They are largely the result of Regulation NMS which the SEC issued in 2005. Some call the resulting new world of on and off exchange trading a model of competition. Others call it a free-for-all that defies oversight and is ripe for system failures and trading abuses. In reality, both descriptions have some truth. Trading competition has led to lower trading costs and faster trading, but it has also opened the door to new problems.

System Failures. One of those problems involves system failures, of which the May 6 flash crash is the most famous recent example. On that day, out of the blue, the futures market suddenly collapsed and dragged the Dow Jones Industrial Average down nearly 700 points, wiping out billions of dollars of value in a few minutes for no apparent reason. Both the futures and stock markets recovered in about 20 minutes, but left investors and traders in shock. After five months of study, a joint CFTC-SEC report has concluded that the crash was essentially triggered by one large sell order placed in a volatile futures market using an algorithm that set off a cascade of out-of-control computerized trading in futures, equities, and options. That one futures order, placed at the wrong time, in the wrong way set off a chain reaction that damaged confidence in U.S. financial markets.

In some ways, the May 6 crash was a high-speed version of the 1987 market crash, where a sudden decline in the futures market led to a corresponding collapse in the broad stock market which led, in turn, to crashes in individual stocks. And it is not the only type of system failure affecting our financial markets. So-called "mini flash crashes," in which one stock suddenly plummets in value for no apparent reason have become commonplace. On June 2, 2010, for example, shares in Diebold Inc., a large Ohio corporation, suddenly dropped from about \$28 to \$18 per share. The stock recovered, but the company was left trying to understand and explain what happened. Even after the SEC initiated a pilot circuit breaker program after the May 6 crash, at least 15 other companies have had similar experiences, including Nucor, Intel, and Cisco. A former senior Nasdaq executive told the Subcommittee that the Nasdaq exchange has experienced single-stock flash crashes 5-6 times per week. The New York Stock Exchange and FINRA told us these crashes are commonplace and attribute them to various glitches in computerized trading programs.

Single-stock crashes might seem to be a minor problem, but what happens if the security that crashes is a basket of stocks or commodities? On November 29, 2010, 3 of the top 5 equities traded by volume were actually baskets of stocks. If a basket of stocks or commodities crashes in value, what happens to the underlying financial instruments? Uncontrolled electronic trading and cascading price declines in multiple trading venues, including in futures, options, and equities markets, could be the result – another May 6th.

Many investors, by the way, are not waiting around to find out if our regulators have fixed the problem. According to the Investment Company Institute, each month since May, more investors have fled our markets, pulling billions of dollars of U.S. investments.

Trading Abuses. System failures are not the only problem raised by our fractured markets. Another problem is their increased vulnerability to trading abuses. Traders today buy and sell stock on and off exchange, simultaneously trading in multiple venues. Traders have told my Subcommittee that orders in some stock venues are being used to affect prices in other stock venues; and that futures trades on CFTC-regulated markets are being used to affect prices on SEC-regulated options and stock markets. Some traders are also using high speed trading programs to execute their strategies, sometimes submitting and then cancelling thousands of phony orders to affect prices.

To get a sense of the trading activity today, take a look at this stack of paper. This stack, nearly five inches high, contains the actual message traffic generated in the futures, options, and equity markets with respect to one major U.S. stock over the course of one second of time. One stock, in one second, produced over 29,000 orders, order modifications, order executions, and cancellations in all three markets. This stack shows in black and white how traders are now analyzing trades in all three markets at once, evidencing how the futures, options, and equity markets are interconnected. Imagine the same stack multiplied countless times, filling this entire hearing room, and the interconnectedness of the markets as well as the potential for system failures and trading abuses becomes alarmingly clear.

One well known trader, Karl Denninger, recently made this public comment about U.S. trading activity:

“Folks, this crap is totally out of hand. And it's now a daily game that's being played by the machines, which are the only things that can react with this sort of speed, and they're guaranteed to screw you, the average investor or trader. Go ahead, keep thinking you can invest.” (Emphasis omitted.)

Regulatory Barriers. While fractured markets and high speed trading are causing new problems and forms of manipulation, they are also leaving our regulators far behind. Traders are equipped today with the latest, fastest technology. Our regulators are riding the equivalent of mopeds going 20 mph chasing traders whose cars are going 100 mph.

Our regulators are confronting at least four challenges. The first is the fact that each trading venue today has its own infrastructure, rules, and surveillance practices. Besides the expense and inefficiency involved, no regulatory agency has a complete collection of trade data from all the venues, much less a single integrated data flow allowing regulators to see how orders and trades in one venue may affect prices in another.

Second, even if regulators had an integrated data flow, the current data systems fail to identify key information, including the names of the executing broker and customer making the trades. That means regulators can't use the electronic records to, for example, trace trading by one person or set up alerts to flag trades. Instead, before any trading analysis can start, regulators have to figure out the broker and customer behind each trade. Patterns of manipulation are hidden.

The third problem is that the SEC has no minimum standards for automated market surveillance by Self-Regulatory Organizations (SROs), and the quality of those efforts is

apparently all over the map. Recent SEC examinations of certain exchanges have found, for example, some ineffective surveillance systems that were unable to detect basic manipulations or used such restrictive criteria that they failed to flag suspect activity, exchanges that failed to review some surveillance alerts, and exchanges with only rudimentary or under-budgeted investigative, examination, and enforcement programs.

The fourth problem is that the SEC and CFTC have not set up procedures to coordinate their screening of market data to see if trades in one agency's markets are affecting prices in the other's markets. Given the strong relationships between the futures, options, and equities markets, joint measures to detect inter-market trading abuses are essential.

The impact of the regulatory and technology barriers is demonstrated by the fact that it took the CFTC and SEC five months of intense work to figure out what happened over a few minutes on May 6. In addition, over the past five years, there have been few meaningful single day price manipulation cases. One recent case involves a small trading firm, Trillium Trading LLC, which apparently used phony trading orders to bid up the price of several stocks. In that case, FINRA found that, over a three month period in 2006 and early 2007, Trillium submitted phony orders in over 46,000 manipulations, netting gains of about \$575,000. Apparently, the victims of the price manipulation got annoyed enough to research the manipulative trading and hand over the data to FINRA. Even then it took FINRA four years to reconstruct the order books, prove who was behind the trades, and resolve the matter. Trillium and its executives recently settled the case by agreeing to pay over \$2.2 million in fines and disgorgements.

Traders and regulators have told my Subcommittee that Trillium is not the only company that has engaged or is engaging in price manipulation in U.S. financial markets. In fact, one of the more chilling examples involves suspect trading involving traders located in China. Are overseas traders trying to manipulate U.S. stocks? Our regulators are currently unequipped to find out.

Solutions. The May 6 flash crash and the Trillium case provide powerful warnings that we need to strengthen U.S. oversight of our financial markets to restore investor confidence. Much needs to be done. Recent actions by the SEC to prohibit phony quotes, impose single issue circuit breakers, and set up a consolidated audit trail are important advances. But there is a long, long way to go, particularly with respect to coordinating market protections and surveillance across market venues, and across the futures, options, and equities markets.

There also needs to be a greater sense of urgency. The SEC's proposed consolidated audit trail is expected to take years to put into place and won't cover all the relevant products and markets. Requiring executing broker and customer information – an essential component to effective oversight – is in limbo pending completion of the consolidated audit trail, as is integrating the trade data from multiple trading venues. Integrating trading data and market surveillance of the futures, options, and equities markets by the CFTC and SEC isn't even on the drawing board.

I hope this hearing will help inject greater urgency into strengthening U.S. oversight of our fractured, high speed markets to restore investor confidence.

The Divided U.S. Stock Market: Exchange and Off-Exchange Trading Today

