WILLIAMS & JENSEN, PLLC

Fr: Alex Barcham and Aaron Kahn

Re: Security Traders Association 86th Annual Market Structure Conference – Day 3

Dt: October 4, 2019

Summary

On October 4, the Security Traders Association concluded its 86th Annual Market Structure Conference. The panels and discussion included: (1) a fireside discussion on FINRA and Market Oversight; (2) Digital Assets; and (3) an interview with SEC Commissioner Hester Peirce. There was also a breakout panel on Rule 606 which is not included in this summary.

Fireside: FINRA: Overseeing Today's Markets

Moderator:
Len Amoruso, Murphy & McGonigle

Panelists:
Tom Gira, Executive Vice President, Market Regulation and Transparency Services, FINRA
Matt Levine, Deputy General Counsel and Chief Compliance Officer, Virtu

Len Amoruso (Murphy & McGonigle) said that the SEC's Market Access Rule (Rule 15c3-5) required broker dealers to comply with a wide range of regulatory rules and systems integrity requirements. He said that the rule was adopted in 2010 but continues to be a mainstay at FINRA and the SEC. He asked Gira how FINRA approaches Rule 15c3-5 enforcement. **Tom Gira (FINRA)** said that it is something FINRA looks at in an exam. He noted that while there has been a steady amount of cases pertaining to this rule he believes that the total number of these cases has been declining in recent years. He said that like best execution examinations, they focus on regular and rigorous procedures. He said that looking back over the past 10 years he can say that the industry is in a much better place. He said that soft blocks present opportunities to assess various matters. He said that many times price limits make sense but that there are gaps in the limits that sometimes do not make sense. He said that size limits are sometimes one-size-fits-all and are very large. He said that FINRA is also focused on firms' annual reviews. He said that firms should be looking at the appropriateness of calibration. He said that certain access rules may exclude various desks. He suggested looking at scope to ensure that programs are applied across entire firms. He said that aggregation is still an issue and that many firms have a variety of systems in place. He said that oftentimes there is not an aggregation of activity.

Amoruso said that Rule 15c3-5 covers a variety of areas. He asked what key challenges exist from broker dealers' perspectives and in trading firms. **Matt Levine (Virtu)** said that the industry as a whole has gotten better at the rule and that often times erroneous trades result in erroneous filings. He said that firms that have older systems and order flows will have some trouble calibrating. He said that an erroneous event can cause trouble and that firms are getting better and that he is seeing fewer filings. He said that overall the industry is improving but that systems are what they are and

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that calibration across multiple systems remains a challenge. He said that regular exemption can take place and that firms also need to understand how the program works and what level of memorialization is needed. He said that firms are challenged by these concerns. He said that program evolution is needed in order to maintain reports and certifications. He said that the rule requires automated controls but that for a firm to be robust people need to monitor and engage when they encounter problems. He said that people are always needed and that there need to be good methodologies for communicating and disseminating information. He said that such people need to have the appropriate authority and information. He said that firms need to consider these challenges as they look at compliance, software, release controls, and other requirements. He said that big firms encounter constant changes to their regulatory schemes.

Amoruso said that there are multiple variables and conflicts of events. He asked whether 100 percent compliance with Rule 15c3-5 is even possible with so many variables and in a dynamic marketplace. **Gira** said that it all depends on the severity of the event. He said that certain things cannot be eliminated simply because the market is so complex. He said that reasonable procedures are important and that in reality 100 percent is not attainable. He said that there should be constant striving to improve even though there may be some problems.

Amoruso said that in 2016 FINRA started to disseminate report cards based on data collected from a variety of sources. He said that these report cards did not specify rule violations but that they did raise concerns for firms to act upon. He asked Gira how this practice was conceived of and implemented. **Gira** said that now that the Chicago Stock Exchange is on board there is 100 percent exchange participation. He said that the alerts often pertained to dispersal of order flow. He said that 90 percent of the alerts involve two or more exchanges, and 70 percent involve two or more broker dealers. He said that this is trending up. He said that alerts involving multiple broker dealers are aimed at making firms notice when activity generates red flags. He said that periods of time during which problematic trading is occurring are identified but that more specific information is not released. He said that procedures were put in place to try to identify spoofing. He said that alerts have gone down 90 percent since the report cards were started. He said that relationship alerts have declined 95 percent across the board. He said that this is all about compliance and empowering firms to do things to help themselves. He said that non-relationship alerts are most heavily targeted and that these types of alerts have declined.

Amoruso asked Levine how the reports are factored into surveillance programs. **Levine** said that the reports are factored in to complement existing surveillance. He said that firms are looking at the reports and are trying to identify whether any problems exist. He said that the reports do have several false positives but that they are still useful in their ability to provide certain data points. He said that the reports have improved over time and that the ability to interpret reports has improved over time. **Gira** said that FINRA did weigh how to best construct the reports in order to address false positives. He said that machine learning and artificial intelligence are starting to be used. He said that the goal is to have fewer false positives.

Amoruso asked whether there is any duplicative regulation looking at the same issues and asking the same questions. **Levine** said that there is a large amount of regulatory duplication. He said that many exchanges are taking back their programs rather than having FINRA do it all. He said that managing compliance programs can be a drain on resources when the same questions are being answered multiple times. He said that there ends up being several different regulators covering the same subject matter and that this is not an efficient use of time. He said that regulators and firms are all different and that an understanding of each entity's unique qualities is needed. He said that it would be great if there could be more coordination. He expressed concern that some offices within FINRA do not communicate with each other.

Amoruso asked what Gira thinks of the oversight programs for different exchanges. He asked whether efforts to streamline duplication are effective. He asked if this will be a continuing issue. **Gira** said that a model has developed where exchanges are doing a great deal of surveillance of on themselves. He said that right now the reality is that FINRA is the only regulator who can do cross-market surveillance. He said that CAT will be available to everybody. He said that trying to regulate in a way that minimizes duplication is key. He said that focusing on how to take steps to avoid or minimize duplication is a process that is under way. He expressed concern that more duplication could continue and said that he believes that FINRA does an effective job.

Amoruso asked what technological advances, challenges, and other matters may arise in the coming year. **Levine** said that there are many new regulatory items like Rule 606 requirements, CAT phase I, and CAT phase II. He said that forms are being changed and being given new formats. He said that many regulations will be impactful and will change best execution. He said that businesspeople like deterministic things. He said that uncertainty and complexity create problems. **Gira** said that all of the new CAT deadlines have been hit so far but that there are many moving parts with this regulation. He said that with CAT comes big data and that he has seen this with pre-CAT. He said that this will lead to utilization of the cloud and artificial intelligence. He said that surveillance will be revamped in 2020 and beyond so as to utilize machine learning, both supervised and unsupervised.

Gira concluded by pointing out there will be some changes to continuing education including an extension on the ability of individuals who leave the industry to keep their registration for up to two years if they take continuing education. He said that it is important to stay aware of this, as a notice will be coming out in the next month or so.

<u>Panel: Digital Assets</u>
Moderator:
Frank Chiparro, The Block

Panelists:
Brian Kelly, Founder & CEO, BKCM LLC
Tim McCourt, Managing Director, CME Group
Christine Sandler, Head of Sales and Marketing, Fidelity Digital Assets

Frank Chiparro (The Block) asked for an update on what the panelists were doing on digital assets. **Tim McCourt (CME Group)** said in December 2017 the CME launched its Bitcoin future. He noted they have announced that they will be doing options on their Bitcoin future. He asserted that they are happy with the uptake thus far. **Christine Sandler (Fidelity Digital Assets)** said Fidelity's digital journey goes back to 2014 when they began studying distributed ledger technology (DLT) and mining digital currency. She said they began with pilots allowing their employees to buy lunch and make charitable donations in digital assets, noting that the charitable endeavor is still running. She noted that Fidelity is working to reduce frictions in the digital assets space and has built a digital asset custodian. **Chiparro** asked if Fidelity is a digital asset broker. **Sandler** said they are not a broker, but they allow people to trade directly out of the custodian. **Brian Kelly (BKCM)** said in 2012 he went on CNBC and called Bitcoin a scam, which he now regrets. He stated that he bought his first Bitcoin in 2013 and has followed the development of the market. He suggested that this industry is moving incredibly fast.

Chiparro said people are still waiting for the industry to move into the crypto space in a big way, but it has not happened yet. He stated that the big hedge funds have not yet moved into this space. He asked what is holding back greater involvement. **Kelly** said there is a lack of regulatory protection and some ancillary services are missing from the market, such as auditing.

Chiparro asked what clients the panelists see moving into cryptocurrencies. **Sandler** said the client profile is changing. She said there is a pretty big trend in global macro funds moving into cryptocurrency. She noted that she is also seeing longer duration players moving into this area, suggesting that they think it is appropriate to move 1-2 percent of their assets into crypto. **Chiparro** suggested that they view crypto as an asset class like gold. **Sandler** said she does not try to convince people to invest in crypto, but rather Fidelity is trying to create infrastructure which eliminates the operational risks. **Kelly** said Bitcoin is currently uncorrelated, but this may break over time. He suggested that volatility tends to die down in new asset classes over time. **McCourt** stated that Bitcoin is volatile, but not necessarily the most volatile asset people hold in their portfolios. He stated that the Bitcoin future helps people who want an onramp into the crypto space without having to directly hold the assets. He stressed the need to avoid judging cryptocurrencies with an institutional bias.

Chiparro said the developments in equity market structure and in the crypto space are not the same. He said fee compression has been in the news recently. He said TD Ameritrade has reduced its fees to zero, but Coinbase and other crypto brokers have raised their fees. **Sandler** suggested that this evolution will come to crypto when brokers create interoperability. She said the development of an application programming interface (API) and consolidated quote feeds will lead to improvement in the crypto market. **Chiparro** asked if crypto exchanges will ever cooperate and create a consolidated tape. **Sandler** said they do not have to reach that place. She asserted that crypto is a very opaque market and most of the trading occurs over-the-counter (OTC). She stated that Fidelity is trying to gather information and create a better view of the market.

Chiparro said there are unusual incentives in the crypto market, particularly in the Asian markets. **McCourt** agreed that there is more freedom and creativity in the unregulated OTC crypto markets. He stated that there are significant differences between the crypto markets and equity markets. He stated that CME is much more regulated and transparent than the OTC crypto platforms.

Chiparro asked if having so much trading in the unregulated markets is holding this space back. **Kelly** responded in the affirmative. He asserted that Asia is the price driver in this market. He suggested that this space is still the "Wild West," suggesting that the SEC did not approve a crypto ETF because so much of the trading in the market is unregulated. **Chiparro** asked how BKCM interacts with these unregulated exchanges. **Kelly** said they do not keep money on these exchanges for long in order to mitigate risk. He stated that most of the volume in the market is OTC.

Chiparro asked how the OTC space is developing compared to the exchange space. **Sandler** said Fidelity puts liquidity providers through a robust due diligence process. She said their system is based on an API structure, so if a provider cannot connect to that it is a problem to work with them. **Kelly** told a story about people buying Bitcoins with duffle bags full of cash several years ago, emphasizing that the market has evolved since then. He said the market still uses a lot of voice trading, but it is growing rapidly. He said he currently has to look on each broker's website to see their liquidity, but eventually there will be a consolidated tape. **Chiparro** asked if Fidelity will build that tape. **Sandler** said they are moving in that direction, but they will not require firms to trade exclusively with Fidelity. She emphasized that they want to create a reliable and trustworthy onramp for crypto. She stated that audits play a big role in the institutional world, stating that they will have to play a role in crypto. She said the Big Four auditing firms have shied away from this space, but are now coming in and examining the market more critically. **McCourt** said ideas like prime brokerage, financing, repo, and overnight lending are just starting to come into the crypto space, noting that they took many years to develop in the traditional markets.

An audience member asked if moving into the crypto space is easy or difficult for equity professionals. **Sandler** said new entrants need to be willing to learn on a constant basis. She stated that it is a very different marketplace, noting that there is no closing price as the market never closes. **McCourt** said new entrants need to be aware of the product, but do not necessarily need to be experts. **Kelly** said there are unbelievable opportunities for people who can price volatility accurately. He acknowledged that there is a steep learning curve.

An audience member asked how a lack of regulation, and associated volume manipulation, impedes adoption of crypto. **Chiparro** suggested that a large percent of volumes are faked. He suggested that traditional large players may not want to risk their reputation. **Kelly** asserted there has been manipulation in every market, suggesting that there is no difference in the crypto market. **McCourt** said regulatory clarity would help people to take the last step into the market. He stated that while regulation is often viewed as an impediment, it could help to provide clarity on the rules of the road for the next several years. He said participants are coming to CME because of the regulation they provide. He pointed to the development of the reference rate.

<u>**Interview: SEC Commissioner Hester M. Peirce**</u>

Interviewer:
Mina Nguyen, Managing Director, Jane Street

Mina Nguyen (Jane Street) asked Peirce about her leadership on cryptocurrency issues at the SEC. **SEC Commissioner Hester Peirce** noted that Representative Warren Davidson (R-OH) has also been a leader on cryptocurrency issues. **Nguyen** asked how corner stores will be using crypto in 20 years. **Peirce** said crypto will be a routine payment method in 20 years, though maybe not at corner stores. She suggested that multiple assets will be in use. **Nguyen** asked how Peirce explains crypto to people. **Peirce** said she describes it as money of the internet. She explained that it is a store of value. She noted that digital assets can just be representations of a stock or underlying asset. **Nguyen** asked about the Commodity Futures Trading Commission (CFTC) moving forward on regulating cryptocurrencies as commodities. **Peirce** noted that the day prior the CFTC held a Technology Advisory Committee (TAC) meeting regarding cryptocurrency. She stated that she saw tweets arguing that the CFTC is far ahead of the SEC on crypto, which she does not agree with. She said the SEC has been working with the CFTC on a lot of issues recently, noting that she has worked with CFTC Commissioner Brian Quintenz on cryptocurrency.

Nguyen said regulators, and people in general, tend to worry about the unknowns. She asked how much fear of the unknown affects regulators and stifles innovations. **Peirce** acknowledged that regulators do fear the unknown. She stated that it is impossible to know all of the future consequences of cryptocurrency. She said it is easier for regulators to be conservative and avoid

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blame for approving products which cause problems. She stated that she encourages the SEC to support innovation, stressing that blame for all problems in the market should not be placed on regulators.

Nguyen said Peirce's work has been guided by her views on the role of government. She noted that as a Senate staffer Peirce worked on the Dodd-Frank Act (DFA), which she opposed. **Peirce** said the government should not be filled with people who think government is the first and best solution. She stated that the government needs people who see the benefits of innovation through the open market. She stated that as a regulator she assesses whether the private sector is developing solutions or whether government intervention is needed. She said she found working on the Dodd-Frank Act frustrating, suggesting that the crisis was partly caused by behavior encouraged by government regulations. She said government regulation was one cause of the crisis, stating that she opposed centralizing more decision making in the government. She expressed concern that there will be negative consequences from the DFA and emphasized that it should be changed over time. She said the DFA was passed at a scary time and there was a desire to create more certainty. She stressed that regulators must continually look back and evaluate their rules.

Nguyen asked if she believes markets are efficient. **Peirce** stated that markets are dynamically efficient. She said there was a government trigger to the 2007 financial crisis, stating there was also bad activity in the market. **Nguyen** asked how regulators view financial theories. **Peirce** said former SEC Commissioner Michael Piwowar pointed out to her that the SEC examines decisions made by investors on a security-by-security basis, rather than looking at their entire portfolios. She said this affected her perspective as a regulator. She said the securities industry is closely intertwined with regulation. She suggested that having to oversee so many regulations prevents the SEC from considering the efficiency of the market. She said she is pleased that the SEC has brought in more economists.

Nguyen said people always want more transparency on what participants and asset managers are doing. She suggested that this information is very hard to dissect. She asked about the role of government in collecting data, particularly in regards to the Consolidated Audit Trail (CAT). **Peirce** said it is tempting for government to collect lots of data, suggesting that it is easy for them to pass rules to collect it. She stressed the need to be careful about imposing data collection requirements, stating that the regulators must examine whether they need it and can protect it. She said she is now more disturbed by the development of CAT and the amount of data it will collect. She pointed to a news story about a man who tracked women and followed them around, and she compared this to what CAT will do to market participants. She said CAT is imposing surveillance over people who have done nothing wrong. She stated that CAT will take surveillance to a new level, by tracking everything retail investors do. She stated it took her a while to see the consequences to liberty are rather severe. She also expressed concern over Form PF, suggesting it should also be reformed. **Nguyen** asked if CAT should be modified or if there should be a market solution. **Peirce** said it took a long time for the SEC and the CFTC to piece together the causes of the Flash Crash. She stated that over time the justification for the CAT has changed and shifted towards being a tool for the SEC's enforcement program. She said more can be done on enforcement, but questioned whether CAT is necessary for enforcement, suggesting that the "liberty cost" is not worth it. She stated that there is a better case for getting transaction data for firms which are more active in the market, though she still has concerns about doing so.

Nguyen said the CAT is a very costly project for participants, suggesting that cost is a barrier to entry. She pointed to the consolidation in asset management, questioning whether government regulations are driving this trend. She suggested that government regulations may be pushing consolidation and creating systemically risky firms, questioning whether the SEC will need to break these firms up. **Peirce** said she is aware of the high burdens of regulations and the challenges of being a small firm. She stated some of the barriers to entry come from the market being very technologically intensive, stating that regulation is not the only barrier. She asserted that it is not the role of the SEC to break up big entities, but the SEC should look at regulatory barriers to entry. She said reducing barriers to entry will encourage competition.

Nguyen pointed to the SEC's recent ETF rule, stating that people are pleased with it. She asked what other areas the SEC should focus on to avoid regulation being a barrier to innovation. **Peirce** said the SEC should use the ETF rule as a model for addressing areas where there is an uneven playing field. She suggested that the SEC should look at things like recordkeeping rules, suggesting that they impose outdated requirements which are expensive to comply with. She said the SEC's advertising rules are very old and did not contemplate modern methods of communication, suggesting that they should be modernized. She said their offering rules could also be liberalized, including around crowdfunding.

Nguyen asked if Peirce uses an iPhone or Android. **Peirce** said she uses an Android. **Nguyen** asked if Peirce would rather go to a golf driving range or a car driving range, to which **Peirce** responded that she would rather go to a car driving range.

An audience member asked for Peirce's views on the Order Protection Rule (OPR) and its impact on market structure. **Peirce** said she has been very critical of the OPR, as it is the government mandating how the market should operate. She questioned the need for Regulation National Market System (NMS), stating that the capital markets are core of the rest of the economy, suggesting that they are very good at working together. She said the SEC will probably not address Regulation NMS, but she suggested the SEC should review liberalizing the OPR. She said Regulation NMS has had some positive effects, stating that retail investors are served very well by the markets, but argued that overall Regulation NMS got things wrong.

An audience member asked if there is a race to the bottom with the recent announcement by Charles Schwab that they were eliminating trading fees. **Peirce** said regulators need to ensure that firms are transparent about how they are getting paid, suggesting that this should be their focus. She stated that retail investors who do not trade very often are different from more frequent traders and need different information.

An audience member asked how the industry can keep the SEC better apprised of technological innovations in the market. **Peirce** urged the industry to reach out and meet with the SEC.

An audience member asked what Peirce has learned from reaching out to businesses in the middle of the country rather than just the U.S. coasts. **Peirce** said the middle of the country is at a disadvantage, partly due to regulation. She stressed the need to revise the accredited investor definitions, and she recommended allowing more flexibility with micro offerings. She explained it is more difficult for people in the middle of the country.

An audience member asked how Peirce would caution people about considering environmental, social, and governance factors (ESG) in investment decisions. **Peirce** said she would not caution them against having an ESG-centric portfolio, but stressed that people should not force others to have ESG-centric portfolios. She urged people to "read the fine print" on things which label themselves as ESG, suggesting that they may not meet the investor's definition of ESG.

Nguyen asked about the SEC's work on disclosures and the ability of investors to understand fine print. **Peirce** said the SEC has looked at how firms communicate with customers and how they can make their rules more accommodative of how people want information. She stated that she has been frustrated by the slow pace of progress. She pointed to Regulation Best Interest, asserting that she pushed the SEC not to make paper disclosures the default. She said firms should be allowed to communicate with people in their preferred method.

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