CHICAGOLAWBULLETIN.COM

Serving Chicago's legal community for 157 years

MONDAY, AUGUST 27, 2012

Chicago Daily Law Bulletin

Volume 158, No. 168

Markets need more progressive oversight

BY JENNIFER L. ZORDANI

Jennifer L. Zordani is a partner at Ungaretti & Harris LLP. She has a practice that encompasses transactional, regulatory and litigation matters with a particular emphasis on issues affecting financial services firms. She can be reached at jlzordani@uhlaw.com.

On Aug. 1, Knight Capital, a broker-dealer that is a market maker, made a nearly fatal error in using a new software program to execute trades. Its program failed. For about 45 minutes — an eternity in today's markets — Knight's quotes and executions ran amok and caused wild gyrations in the equities markets. It failed to fulfill its obligations to maintain a fair and orderly market and its risk management was so abysmal that, according to news reports, the program failure continued despite immediate questions from exchange personnel. When it finally turned off its program, Knight had lost hundreds of millions of dollars and had brought itself to the verge of bankruptcy. Saved from insolvency by a capital infusion from other broker-dealers, Knight continues as one of the largest executing brokers in the United States.

Knight's resilience after its debacle reveals that the foundation of the U.S. equity markets, if not perfectly solid, is not crumbling. First, investors appear to have emerged from the 45 minutes of chaos relatively unscathed. According to Knight, its customers did not suffer losses. While it remains to be seen if other market participants have claims against Knight, the group most at risk appears not to have been harmed. Second, industry investors kept the firm in business, thus maintaining competition in that space. And most importantly, there is no doubt that the Securities and Exchange Commission will learn precisely who and what caused the failures. Regulations that apply to all broker-dealers (e.g., the new Market Access Rule) and market makers in particular, permit the SEC to sanction the firm and individuals responsible for the failures. The regulations also may permit the SEC to sanction the exchanges or other market places where the failures occurred.

The lack of an immediate harm to anyone other than Knight's shareholders is cold comfort. Knight's debacle is another reminder that the foundation of the U.S. equities markets consistently needs shoring up. In order to maintain the strong foundation, there has to be a universal recognition that brokerage and trading is conducted using computers and software programs. Modern markets must be able to accommodate, monitor and regulate all forms of computerized trading. There is simply no going back. Indeed, market participants, regulators and legislators should warmly embrace this new normal as they build better and stronger markets.

Tossing about gross generalizations and pejorative comments about computerized trading and "high frequency trading" makes it easy for pundits and politicians to offer purported fixes when in reality they offer nothing that would shore up the foundation of the U.S. equities markets.

The most spurious fix, offered once again after the Knight debacle, is a transaction tax. The argument begins by painting all traders with the same brush. For example, one argument starts with the generalization that trading programs are designed to trade ahead of large trades. Next, commentators suggest that even the smallest speculation tax or transaction tax would raise billions for the government coffers and would only moderately raise the cost of transactions. Restricting activity by taxing it, of course, does not actually fix anything or strengthen the markets.

> *"Knight's debacle is another reminder that the foundation of the U.S. equities markets consistently needs shoring up."*

Rather than trying to turn back the clock, investors might be better served by discussions and solutions that recognize the financial markets have never been, and never will be, entrenched in the past. There are numerous debates about trading and market structure (e.g., payment for order flow) with interesting ideas to be explored, but proposals, like a transaction tax, that rely on gross generalizations and are devoid of any evidence that they would make the equities markets stronger must be avoided.

Investors also will be better served by discussions that recognize there are no quick fixes to strengthening the markets. A myriad of complexities arise. They are briefly illustrated by two recent actions taken by the SEC.

In July, the SEC adopted Exchange Act Rule 613 which requires securities exchanges and Financial Industry Regulatory Authority (FINRA) to develop a consolidated audit trail, i.e., an order tracking system for exchange listed equities and equity options. The system intended to result from Rule 613 seems similar in some respects to FINRA's OATS — an order tracking system of unknown utility and one that is notoriously burdensome, particularly on small firms and firms with business models that differ from the norms. Thus, it remains to be seen if the SEC will be able to avoid the pitfalls of accepting what is familiar and demand that its self-regulatory organizations implement systems of known utility. Rule 613 was years in the making and it will be a couple more years before it is fully implemented.

The SEC also recently created an Office of Analytics and Research. This specialized office will analyze the voluminous market information submitted to the SEC. The Dodd-Frank Act increased the amount of information that must be submitted to the SEC (and other regulators). While it is not progressive by any means, the new office evidences a thoughtful allocation of resources. Ultimately, this might allow the SEC to parse useful information from extraneous information and better tailor the many filing requirements imposed on market participants. This will not happen overnight.

These examples are admittedly incomplete illustrations of the complexities involved in regulating traders and other investors. They also illustrate that more precisely crafted and thoughtful regulation is more likely to be effective in policing the markets, less likely to further drain regulators' resources and less likely to increase the barriers to entering the financial markets. While these are decidedly traditional goals, they should remain front and center when we are confronted with something like the Knight debacle. These goals remain laudable in today's markets.

Copyright © 2012 Law Bulletin Publishing Company. All rights reserved. Reprinted with permission from Law Bulletin Publishing Company.