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Statement No. 276

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Statement of the Shadow Financial Regulatory Committee on

Regulatory Initiatives of the Securities and Exchange Commission

September 14, 2009

Amid the market turmoil and sense of crisis of the last year, there has been enormous pressure on the government to be seen to be doing something in response. It is always popular among politicians to go with the tides of public opinion and come up with some idea that must be immediately enacted. But that is not a formula for well-thought-out policies that are based on careful understanding of an issue and consideration of likely consequences.

The Administrative Procedure Act, passed more than sixty years ago, requires regulatory agencies to follow a deliberative process in rulemaking that is open to public view, except in genuine emergencies. But members of Congress, to which the Act does not apply, often seem to hold it in low regard.

A recent example in the case of the SEC is the newly-discovered problem of "flash" orders, in which some market orders are displayed in a particular platform for a small fraction of a second to other traders before being executed, giving rise to the possibility that they can obtain information profits or better execution than other investors. Senator Charles Schumer (D-NY) seized on the issue, phoned SEC Chairman Mary Schapiro, and publicly announced that he had obtained assurance of an "imminent ban." Chairman Schapiro in a tactful response said that she had asked the staff "for an approach that can be quickly implemented" and noted: "Under the rule-making process, such a proposal… would need to be approved by the Commission and open to public comment."

The SFRC strongly supports Chairman Schapiro's response to the kind of inappropriate Congressional pressure that is unfortunately only too common, although usually less visible. We comment on the merits of this and another issue below. But we are concerned that purportedly independent regulatory agencies have the necessary public support to do a conscientious job of administering the important duties with which they have been entrusted.

Not only is the SEC now facing pressure to eliminate flash trading, it has also been under heavy pressure for some time to limit short selling. In both of these cases, the SEC needs to preserve its independent integrity and judgment. It needs to undertake careful empirical analyses of the impact on the financial markets before taking any regulatory action—be it for short sales, flash trading, or any other issue.

In the case of short sales, the SEC is under continuous pressure to reinstitute restrictions. In 2005-2006, the SEC conducted a pilot experiment to examine the effects of pricing restrictions on short sales. It undertook the collection of vast amounts of data on short sales, both on stocks with restrictions and on stocks with them temporarily removed, and released these data for study to outside researchers. The agency also examined the data internally. It found no obvious deleterious effects of removing restrictions on short sales, and in 2007 the SEC repealed the previous restrictions, such as the NYSE rule barring short sales on down-ticks (See Statements No. 261, September 15, 2008, and No. 274, May 4, 2009).

With the large market declines in individual stocks over the past year or so, the SEC is under renewed pressure to again restrict short selling. It has recently issued a request for comment on a proposal to prohibit short sales at the best national bid (the price at which there is a ready buyer) and permit them only at a price above this bid. The economic basis for such a rule appears weak at best. As before, the SEC should undertake careful economic analysis to determine the effect of such a rule before bending to political forces.

Similarly, with flash trading, the SEC needs to carefully collect and analyze the data to determine the effect of such trading on investors and the public. It is not at all clear that flash trading is harmful to the investors as a whole. On the one side, flash trading may bring additional liquidity to the market benefiting all investors; on the other side, flash trading may allow some investors to obtain better executions or profits than others.

Additionally, flash trading (like all innovation) can affect market share among trading venues. Following the introduction of flash trading by Direct Edge, three other market venues began offering similar products. Now, whether due to political heat or a lack of sufficient market demand, two have withdrawn their offerings of flash trading. Either way, the SEC reaction should be based on its professional judgment underpinned with careful empirical studies and not on accommodating political pressure.