

Testimony of
David E. Durbin, Executive Director
Pennsylvania State Employees' Retirement System
before the
Pennsylvania House of Representatives State Government Committee
regarding
House Resolution 701

April 1, 2014 – 9:00 a.m. – Room 60, East Wing

I am Dave Durbin, executive director of the State Employees' Retirement System; with me is Tom Brier, SERS' acting chief investment officer.

As you may know, during SERS and PSERS budget hearing, Representative Mustio introduced the notion that there may be new technology to potentially allow investors to more accurately identify when a stock trade is not executed within the Security and Exchange Commission's (SEC) "national best bid offer" (NBBO) framework.

As HR 701 rightly indicates, SERS has a fiduciary duty to its members. It's an obligation we take very seriously. On any given day, SERS' staff is actively investigating the performance of current and potential investment managers as well as researching ideas, products and services that may help improve our stewardship. Thus, it was the natural application of our day-to-day commitment that caused us to begin research shortly after the hearing.

Specific to today, HR 701 encourages SERS to embrace new technology that purports to be able to identify stock trading price violations. Once identified, there is an implication that it will be easy to recover sums related to each transaction. As we understand it, the technology is designed to scrutinize trades covered by the SEC's Reg NMS Rule 611, a complex framework for stock exchanges and firms regulated by the Financial Industry Regulatory Authority (FINRA).

The SEC and the exchanges' compliance functions are vigilant in identifying and correcting violations. In fact, in January 2013, the SEC rolled out its own Market Information Data Analytics System (MIDAS). Among other things, it uses microsecond time stamps to analyze orders and quotes on national exchanges as well as trade executions against those orders. Admittedly, our research has not been comprehensive, but we think it's important to let you know that SERS has not yet uncovered evidence that would support claims of large-scale, unaddressed violations.

In the past weeks, we have scanned a number of sources and have, so far, found very little litigation in this area: none specifically related to Reg NMS, which is suggested as being so prevalent, and none including a public pension plan. We did find three SEC administrative matters, two against exchanges and one against a broker. FINRA's online database revealed one disciplinary action and ordered a company to pay restitution for failing to provide customers with best execution in certain transactions.

We also reached out to our industry associations and peer networks. To date, we have received no responses to indicate that others sense that NBBO violations are occurring unchecked. We heard from some other states that looked into technology-based offerings but decided not to move forward either

because they believed their current monitoring scenarios to be providing sufficient risk mitigation or because they had not identified a vendor that met the due diligence criteria they employ to meet their fiduciary standard, particularly as related to relevant references and evidence of success.

None of this is to say that violations do not occur; I'm sure they do. Even when all parties act in good faith, mistakes can be made and dynamic markets evolve rapidly. I think you might be interested – at a very high level – in knowing more about the safeguards SERS has in place to avoid, monitor and address potential problems.

Our first line of defense is an aggressive offense. As fiduciaries, one of our overriding concerns is to only engage the highest quality investment managers. Our standard due diligence process related to any manager who may invest in the public markets is multifaceted. One key component is an 18-page set of questions which seeks to uncover evidence related to matters such as history and outcomes of regulatory reviews; order management systems; trade execution quality monitoring processes; trade cost analysis; examples of error correction; compliance monitoring; exception reporting; and similar, detailed information about the manager's affiliated brokers or firms.

Even after we verify that we are engaging high-quality managers, we don't simply take it on faith that every firm engaged by every manager executes every trade without error. Thus, we verify.

In 2011, after a competitive bid, SERS renewed its contract with the firm Abel Noser to provide third-party monitoring of trade execution quality and trader commissions. The firm performs a detailed analysis of equity trade data against the volume weighted average price prevailing across SERS' trades on a quarterly basis. The foundation for their review is a broad data set that includes every SERS transaction that occurred during the quarter, as provided by our custodial bank. In this respect, SERS uses an industry-standard practice of monitoring execution levels related to market benchmarks and total commission costs. It is crucial in identifying anomaly trends that may emerge by security, by broker or by manager. SERS execution performance has ranked in the top quartile when compared to all peers in the Abel Noser universe.

During the contract period thus far, Abel Noser has evaluated more than 500 million SERS' shares traded on domestic exchanges and has flagged fewer than 10 situations that warranted additional scrutiny. To be clear, there are many reasons that a trade could appear to be out of compliance but – and this is a critical point – appearance alone does not confirm the presence of a violation.

HR 701 asserts that as many as “7.5% of all stock shares have NBBO violations,” and cites “\$20 billion in documented cases” between 2008 and 2013. Representative Mustio's budget hearing questions asserted that 2.3 cents per violation is recoverable. SERS has not been able to independently verify these facts, nor are we comfortable with the implicit validation of damages that they imply. Additional research related to both data and methodology is necessary.

That being said, we understand and share your interest in ensuring that our pension system is retaining every possible dollar. SERS is committed to exploring opportunities that have the potential to help us become an even more efficient organization. Several weeks ago we reached out to and set up a meeting with a potential vendor. Unfortunately the vendor canceled subject to negotiation and execution of nondisclosure agreements between the vendor, SERS and – potentially – our consultants. We are working through those issues now and will continue to move forward in the coming weeks.