SEC's Equity Market Structure Advisory Committee Considers Market Volatility and Customer Issues

FEBRUARY 29, 2016

The Equity Market Structure Advisory Committee (EMSAC or Committee) held its third meeting at the Securities and Exchange Commission (Commission or SEC) in Washington DC on February 2, 2016.[1] The Committee is considering whether various regulatory or industry initiatives would improve the function of the US equity markets. At this meeting, the Committee focused on issues (1) accompanying the market volatility occurring on August 24, 2015; and (2) primarily affecting retail customers, including how certain order types used by retail customers operate, payment for order flow, and execution quality and order routing disclosures.[2] In addition, the four subcommittees of the EMSAC, which were created after the last meeting, provided updates on their respective areas of focus.

As an advisory committee to the SEC, EMSAC is organized and operates pursuant to the Federal Advisory Committee Act.[3] Accordingly, the Committee's proceedings are open to the public, and, while not a formal rulemaking body, it ultimately will make recommendations to the Commission for possible action. Accordingly, market participants with interest in any of these topics should consider whether and how (e.g., a white paper or comment letter) to make their views known to the Committee in a timely manner.[4]

Opening Remarks

Each Commissioner gave opening remarks discussing their views on the agenda items. Chair White highlighted that the SEC has taken action with regard to one discussion point from the prior EMSAC meeting, issuing a rule proposal to enhance the transparency of alternative trading systems.[5] Chair White also noted that the SEC staff completed a research note analyzing the operation of US equity markets under the stressed conditions of August 24.[6] The research note provides detailed data and other information to help assess trading on that day, continuing the SEC's empirical approach to its regulation of the US markets. Chair White also requested comment on potential improvements to the execution quality and order routing disclosures required by Rules 605 and 606 of Regulation NMS, and noted that the SEC staff is developing a rulemaking proposal to enhance the required disclosures, including enhancing transparency of broker-dealers' order routing practices related to institutional investors. Commissioner Stein expressed interest in whether certain market structure features (e.g., order types, payment for order flow) favored certain investor groups. Commissioner Piwowar commented that the SEC Staff's research note regarding August 24 was a good starting point for a study of market volatility.

Market Volatility and the Events of August 24

The Committee first discussed the regulatory issues raised by the market volatility of August 24. To frame the issues for this panel, the SEC Staff summarized the highlights of its recent research note regarding the market volatility on August 24. Among the issues addressed in the note are the opening and re-opening processes at the primary listing exchanges, the effects of market volatility on trading in certain exchange-traded products and corporate stocks, and the operation of the limit up/limit down pilot plan on a day with market-wide volatility. The note provided solely empirical data; the SEC Staff plans to supplement this data with a separate note providing analysis and recommendations.

After the SEC Staff's presentation, the panel and Committee proceeded to discuss: (1) the successes of August 24, (2) how to refine the limit up/limit down trading mechanism, and (3) how to incentivize market makers to continue to provide liquidity during periods of market volatility.

Panelists and EMSAC members generally agreed that, despite the heightened volatility and increased message traffic experienced on August 24, there were noticeable improvements in how the market functioned, especially as compared to the Flash Crash of May 2010. On August 24, market technology operated well. For example, market data delivery systems and post-trade systems did not experience technology issues. Additionally, the new market mechanism to address extraordinary market volatility—limit up/limit down—operated as designed.

Committee members went on to note that, while limit up/limit down may have operated as designed, it may not have operated as intended in light of the difficulties experienced during the re-opening process. Accordingly, panelists and EMSAC members offered several suggestions for improving the function of the limit up/limit down mechanism, focusing primarily on the re-opening auction process. Specifically, several panelists and Committee members suggested amending the rules to address repeat pauses, recoveries after a pause, and significant price imbalances after a pause. However, other panelists and Committee members suggested that, rather than trying to tweak the rule to address that auction process after a reopening, it might be easier to eliminate auctions and re-opening auctions around limit up/limit down altogether. Instead of re-opening auctions, these panelists and Committee members suggested incorporating floating price bands that readjust periodically as well as providing market participants with time to assess the price of the security.

In addition to discussions related to re-opening auctions, the Committee and panelists considered how, if at all, to adjust the limit up/limit down price bands. Several EMSAC members and panelists suggested adjusting the bands such that an incremental shift in the price of a stock could be countered by a congruous incremental shift in the price bands to avoid triggering additional pauses when the stock is rallying from a significant price fluctuation. Additionally, some Committee members and panelists suggested harmonizing the wider opening limit up/limit down bands with the tighter bands applicable for the remainder of the trading day by having consistently wide bands throughout the day. A few EMSAC members and panelists disagreed with widening the bands and noted that the bands are appropriately set and reiterated the need to focus on steps that should be taken to find an accurate equilibrium point after a limit up/limit down pause.

Agreeing that the absence of liquidity was a significant factor in the market volatility of August 24, panelists and EMSAC members discussed the need to incentivize the provision of liquidity during times of market volatility. Many panelists discussed the interplay between the clearly erroneous bands and the limit up/limit down bands noting that the lack of consistency between the two regimes created uncertainty for market makers as to whether their executions would be busted as clearly erroneous and, as a result, disincentivized the provision of liquidity. In response, panelists and Committee members proposed: (1) harmonizing clearly erroneous bands and the limit up/limit down bands to clarify what executions will stand and what executions may be busted,[7] (2) encouraging exchanges to adjust clearly erroneous executions rather than bust those executions, or (3) eliminating the clearly erroneous procedures altogether.

Unrelated to the limit up/limit down plan, one EMSAC member noted that current Regulation SHO interpretations and restrictions hinder a market maker's ability to provide liquidity because they impede a market maker's capacity to engage in arbitrage between various markets/products, e.g., exchange traded products and individual stocks. Several Committee members noted that a lack of transparency on the part of primary exchanges also contributes to the lack of price discovery and ultimately disincentivizes the provision of liquidity. Specifically, Committee members suggested additional transparency, across exchanges, around the exchanges' auction processes. They also suggested that exchanges provide information regarding order imbalances as well as indicative prices until the open.

Issues Affecting Customers in the Current Equity Market Structure

Next, the Committee discussed certain market structure issues that affect retail customers. The Committee primarily focused on three areas during its discussion: (1) the risks raised by certain order types (i.e., market orders and stop orders), especially during periods of short-term market volatility; (2) conflicts of interest raised by the receipt of payment for order flow by broker-dealers handling customer orders; and (3) the adequacy of current execution quality and order routing disclosures. These risks are highlighted in the SEC Staff's memorandum to the Committee.[8]

In discussing the use of market and stop orders by retail investors, the Committee and panelists identified the risks associated with these order types and identified potential alternatives to address the risks. Generally, these orders prioritize immediacy of execution over, for example, the use of a limit price to provide some protection against adverse price movements, particularly those movements that may occur rapidly during times of market volatility. To address the risks associated with these order types, the EMSAC and panelists discussed: (1) prohibiting these order types, (2) providing greater investor education, and (3) limiting the use of these order types during particular periods or relating to particular securities.

Some Committee members and panelists supported a prohibition against the use of market and stop orders. However, many Committee members and panelists preferred the alternative of providing investor education in the form of pop-up warnings when such orders are entered and/or information sheets on client online accounts as well as through conversations between broker-dealers and retail clients. Proponents of investor education reiterated the importance of these order types to retail clients in light of their limited ability to monitor intra-day price movements, as well as the fact that, more often than not, these order types operate as intended. Another subset of Committee members and panelists suggested that investor education alone would be insufficient and that limitations on the use of these orders would strike a better balance between reducing the risk associated with the order types and maintaining customer choice and access to order types. Examples of limitations include: (1) requirements to incorporate limit prices, (2) the addition of maturity or expiration dates for stop orders to remind retail clients of the existence of the stop order, or (3) creating a true stop order by tying the order to an out of the money put.

Panelists and EMSAC members also discussed the benefits and concerns associated with payment for order flow arrangements. In terms of benefits, panelists noted that the firms entering in these arrangements have experienced enhanced execution quality for the orders of retail investors; it was noted that approximately 82% of such orders receive some level of price improvement, approximately 90% of orders execute at the national best bid or offer, and the current spread capture rate is approximately 20%. Other panelists and Committee members noted that, despite these benefits, payment for order flow arrangements also: (1) provide economic incentives that create conflicts of interest; (2) provide nominal price improvement that takes executions away from displayed liquidity providers and provides disincentives for over-the-counter market makers to provide competitive quotations (i.e., tighter spreads); and (3) increase over-the-counter executions, which, consequently, minimizes the incentive to display quotations, and/or provide price transparency or liquidity. The discussion focused on whether the conflicts of interest created by payment for order flow arrangements can be addressed sufficiently through disclosures or whether such arrangements should be eliminated.

Several panelists and Committee members suggested that there is no level of disclosure that could adequately address the conflicts of interest created by payment for order flow arrangements, preferring to eliminate the practice. Many other panelists and Committee members noted that while payment for order flow arrangements are imperfect, retail investors are better off with these arrangements in place. Specifically, proponents of maintaining payment for order flow arrangements noted, among other things, that: (1) in fact, the number of such arrangements is not tending to increase and (2) the elimination of payment for order flow arrangements will not eliminate internalization, which involved conflict of interest concerns similar to those raised by payment for order flow. As an alternative to the elimination of payment for order flow, these Committee members and panelists suggested enhancing disclosures by requiring broker-dealers receiving payment for order flow to provide customers with information on the amount a broker-dealer received as payment for routing the client's order(s) to a particular venue and/or passing payments to retail investors.

Order execution and order routing disclosures also were discussed at the meeting. Generally, EMSAC members and panelists agreed that Regulation NMS Rule 605 and 606 reports should be enhanced to include more detailed metrics including, but not limited to, more granular execution speed and timestamp data; information regarding institutional orders, odd lot orders and limit orders (i.e., whether the limit order is marketable or non-marketable); and spread capture rates. Moreover, Committee members and panelists suggested combining the Rule 605 and 606 reports to allow customers to assess the execution quality received from particular venues as well as the amount of order flow routed to those venues. As stated, Chair White has directed the SEC Staff to consider preparing a rule proposal to amend the requirements of Rules 605 and 606.

Updates from EMSAC Subcommittees

During its last meeting, the Committee formed four subcommittees, each to consider a specific area of interest: Regulation NMS, trading venue regulation, customer issues and market quality. Each of the subcommittee chairs provided an update on their respective efforts to date.

The Regulation NMS Subcommittee intends to address access fees and whether there should be a pilot program related to access fees, market data and the Order Protection Rule. The Market Quality Subcommittee plans to use the events of August 24 to focus on (1) the opening mechanism and achieving consistency across markets, (2) the interplay between the limit up/limit down and the clearly erroneous process, (3) market data, and (4) the appropriate balance of responsibilities and benefits associated with market making. The Trading Venue Regulation Subcommittee plans to prepare a comparative analysis of issues relevant to exchanges and alternative trading systems and build upon the Commission's recent proposal to amend Regulation ATS by considering the regulatory framework across exchanges, ATSs and broker-dealers engaged in analogous activity. Additionally, the Trading Venue Regulation Subcommittee will address national market system plan governance with the intention of having effective industry participation of both buy- and sell-side firms. Finally, the Customer Issues Subcommittee has reviewed data on investor participation, attitudes and education, and has created a sub-group focused on enhancements to Rules 605 and 606. Going forward, the Customer Issues Subcommittee intends to review and address the payment for order flow section of the SEC Staff's memorandum.

Next Steps

The Committee has scheduled its next meeting for April 26, 2016, and the various subcommittees will hold meetings in the coming months.

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[1] The EMSAC is comprised of senior executives from large institutional broker-dealers, self-regulatory organizations, an ATS, technology firms and the AARP, along with academics with specialties in economics, finance, financial engineering, computer science and artificial intelligence, and law. *See*EMSAC Spotlight page, SEC (last modified Feb 1, 2016).

[2] The Committee focused on the Order Protection Rule of Regulation NMS in its first meeting, and access fees and the regulatory structure of trading venues in its second meeting. *See* Andre Owens, Bruce Newman and Mahlet Ayalew, WilmerHale, SEC Equity Market Structure Advisory Committee: Assessing Complexity in the U.S. Equity Markets (May 21, 2015); and Andre Owens, Brandon Becker, Cherie Weldon and Mahlet Ayalew, WilmerHale, Access Fees and Regulatory Structure of Trading Venues, (Nov. 5, 2015).

[3] *See* Federal Advisory Committee Act, 5 U.S.C. app. §§ 1-16 (2015).

[4] Comments submitted to the Committee to date are available on the SEC's EMSAC Spotlight page, as are instructions for submitting public comments.

[5] Mary Jo White, Chair, SEC, Opening Remarks to the Equity Market Structure Advisory Committee (Feb 2, 2016); *see* Andre Owens, Bruce Newman, Brandon Becker, Cherie Weldon, Jeremy Moorehouse and Mahlet Ayalew, WilmerHale, SEC Proposes Significant Regulatory Changes for Alternative Trading Systems, (Jan. 4, 2016).

[6] Staff of the Office of Analytics and Research Division of Trading and Markets, *Research Note: Equity Market Volatility on August 24, 2015* (Dec. 2015).

[7] One Committee member clarified that if the limit up/limit down bands are widened as suggested by some, the clearly erroneous bands should not mirror the limit up/limit down bands because that would create additional market risk by making the threshold for breaking a trade much higher.

[8] Memorandum from the Sec. & Exch. Comm'n, Div. of Trading & Mkts. To the Equity Mkt. Structure Advisory Comm. (Jan. 26, 2016).

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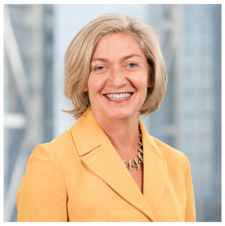

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