SEC Equity Market Structure Advisory Committee: Assessing Complexity in the U.S. Equity Markets

THURSDAY, MAY 21, 2015

On May 13, 2015, the Equity Market Structure Advisory Committee (the "EMSAC" or "Committee") held its inaugural meeting (the "Inaugural Meeting") at the Securities and Exchange Commission (the "Commission" or "SEC") in Washington, D.C.[1] Discussions during the Inaugural Meeting made clear that the primary purpose of the EMSAC is to assess the current complexity of the equity markets. Based on this review, the Committee is to determine whether there are regulatory or industry initiatives that will help ensure that the level of complexity does not exceed that which is necessary to optimally meet the needs of investors and issuers.

The agenda for the Inaugural Meeting was focused on the Order Protection Rule ("Rule 611" or the "Rule") of Regulation National Market System ("Reg NMS"), including two related panel discussions and question-and-answer sessions. The Commissioners and Committee members touched on additional topics deemed relevant to the complexity of the equity markets, including the prohibition on locked and crossed markets, SEC order handling Rules 605 and 606, best execution and market quality, access fees, and the maker-taker rebate model. This alert summarizes the Inaugural Meeting.

Opening Remarks

The Commissioners began the meeting by reiterating the "sweeping transformation" of the U.S. equity markets over the last 20 years and the need to update the U.S. regulatory structure to reflect new ways of doing business. SEC Chair White noted that "much of the concern expressed about [the] current market structure can be distilled to at least a perception that [the market] is unnecessarily complex [in that the complexity] is not directed primarily toward producing better markets for investors and public companies."[2] While acknowledging the need to determine the extent to which SEC rules "have needlessly fostered complexity," Chair White indicated that such rules alone are not responsible for all of the complexity in the current market structure. She charged the Committee with identifying factors within the current regulatory and industry landscapes that have contributed to the current state of the equity markets, beginning with a review of Rule 611, through a "careful, data-driven assessment where no issue is off limits or any assumption unquestioned."[3] Each of the Commissioners also gave opening remarks urging the Committee to take a long-term and holistic view of the markets in developing an agenda and priorities for the Commission's consideration.

Discussion Topics during the Inaugural Meeting

Rule 611

The Inaugural Meeting began with a brief presentation of Rule 611 by the Staff of the Division of Trading and Markets. The Staff noted the two primary objectives of Rule 611 as: (1) protecting investors from executions at inferior prices by reducing trade-throughs, and (2) promoting the display of limit orders. The Staff suggested that the Rule has succeeded in achieving the first objective, but noted that it is less clear whether the Rule has met the second objective. In addition, the Staff noted that while many believe that Rule 611 has increased market fragmentation, it is not clear whether other forces also may have contributed to fragmentation. The Staff asked the Committee to consider the impact of reinstating a pre-Rule 611 regulatory structure on today's markets before any recommendation that the Commission eliminate the Rule.

While many Committee members agreed that investors are better off in today's markets, there was less agreement as to how Rule 611 has affected the markets. In addition to fragmentation concerns, critics noted that the Rule contributes to routing conflicts that impact best execution and also creates unnecessary complexity, overhead, and infrastructure. Some Committee members indicated that Rule 611 subsidizes certain exchanges that otherwise might not be viable. Proponents of the Rule noted that it ensures best prices for customers and has significantly reduced trade-throughs. They argued that the elimination of Rule 611 would negatively impact market confidence and competition.

Many Committee members suggested alternatives to Rule 611. For example, some suggested that Rule 611 should focus on *customer* order protection, where customer orders are given priority over all other orders when proceeding to the top of the order book at an exchange. Others questioned whether Rule 611 creates enough of an incentive for market participants to display their orders.

Some EMSAC members suggested discussing the utility of the Rule as applied to liquid versus less liquid securities. Other Committee members found less value in this approach, noting that it does not appear that Rule 611 has a different impact on liquid versus less liquid securities. Some Committee members thought that executions of block-sized orders should be excepted from Rule 611, while others thought that such an exception could harm the market confidence of retail investors.

Locked and Crossed Markets

Some EMSAC members suggested eliminating exchange prohibitions on locked and crossed markets. Specifically, they questioned how retail investors would have confidence in the markets when their orders do not receive executions because of a locked or crossed market. Committee members in favor of retaining the prohibition noted that locked and crossed markets generally are viewed as indicative of an inefficiency in the market. They also noted that such markets often are the results of routing determinations made based on market rebate programs. They suggested addressing the maker-taker pricing model used by many exchanges and alternative trading systems ("ATS") (discussed below), identifying securities particularly susceptible to locked and crossed markets, and adjusting minimum trading increments in lieu of eliminating the ban on locked and crossed markets.

Transparency

Throughout the EMSAC’s discussions, several Committee members cited a lack of transparency as a critical issue in the markets. Committee members noted that the complexity in the market is particularly concerning given the absence of transparency. To address this, members suggested updating the order handling disclosure requirements of Rules 605 and 606 to provide investors with more insight on the costs associated with the handling of their orders, and to allow them to make more informed order routing decisions.

Best Execution

Committee members and panelists also discussed best execution as an alternative to Rule 611. There was disagreement over the extent to which Rule 611 approximates best execution: one Committee member stated that Rule 611 is a rough proxy for best execution and another opined that the Rule is not a useful proxy for best execution. In general, EMSAC members and panelists noted the need to: (1) incentivize obtaining the best price rather than relying on Rule 611; (2) create a more robust framework for assessing best execution that includes disclosures, conflict checks, an audit trail, independent audits, and quantitative standards; and (3) develop factors to better evaluate market quality.

Maker-Taker Model/Access Fees

Many Committee members and panelists noted that the fragmentation in today’s markets cannot be assessed without also reviewing the maker-taker pricing model used by some exchanges and alternative trading systems. Although there are multiple variations on the theme, the maker-taker pricing model generally involves the offering of rebates to market participants providing liquidity (the “makers”) and the charging of fees to market participants accessing the liquidity (the “takers”).[4] Some Committee members called for the elimination of this fee structure, arguing that it adds unnecessary complexity to the markets. As an alternative to the elimination of the maker-taker model, other Committee members suggested increasing transparency regarding the rebates received by market participants, reducing access fees and/or avoiding a one-size-fits-all approach by implementing a tiered fee structure based on the liquidity profile of each security.

Testing of Ideas Through Pilot Programs

Many panelists and EMSAC members commended the Commission for its use of the Tick Test Pilot Program and strongly encouraged the use of pilot programs to test any changes proposed by the Committee prior to implementation. While agreeing with the suggestion, one Committee member encouraged the Committee to be cognizant of the costs associated with conducting pilot programs. The member suggested beginning with testing changes in access fees because such a pilot program would be less costly for participants than a program related to routing behavior.

Next Steps and Forthcoming Regulatory Initiatives

Going forward, the EMSAC will create subcommittees to consider particular issues and will periodically provide the Commission with recommendations. Stephen Luparello, Director of the Division of Trading and Markets, explained that the Commission currently is addressing order routing disclosures. Additionally, Richard Ketchum, Chairman of the Financial Industry Regulatory Authority ("FINRA"), noted that FINRA is working on a proposal to enhance the monitoring of off-exchange trading (this is in addition to recently adopted FINRA Rule 4552 requiring ATSs to report transaction information under separate Market Participant IDs).

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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.

[2] Mary Jo White, Chair, Securities and Exchange Comm'n, Opening Remarks at the Inaugural Meeting of the Equity Market Structure Advisory Committee: Optimizing our Equity Market Structure (May 13, 2015).

[3] *Id.*

[4] Inverse maker-taker pricing models in which the provider or maker of liquidity is charged a fee and the user or taker of liquidity is provided a rebate also exist.

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