DeltaStrategy Group

SEC EQUITY MARKET STRUCTURE ADVISORY COMMITTEE MEETING

• OVERVIEW

On February 2, the SEC hosted a meeting of the Equity Market Structure Advisory Committee (ESMAC) to discuss the events of August 24, 2015, and certain issues affecting customers in the current equity market structure.

Please click here for the agenda.

• Key Takeaways

- There was broad consensus that the events of August 24th provided evidence that the market opening/ reopening process should be reexamined – and that eliminating an auction process altogether should be considered.
- There was support for considering changes to/ elimination of clearly erroneous rules, given that Limit Up Limit Down rules (LULD) are now implemented.
- Many participants felt that stop orders in particular played a role in the events of August 24th and that investors may not understand the implications of these orders in times of market stress. Also, there was broad agreement that additional investor education would be valuable to provide investors better disclosure regarding the implications of stop orders.
- The EMSAC Subcommittees have been active and will continue to be the venue where real decisions are made.

• SUMMARY

• Opening Statements

Chair Mary Jo White

- The Commission continues to have a sharp focus on equity market structure – noted progress through the Reg ATS proposal.
- Noted the formation of four Subcommittees within EMSAC to facilitate discussion and progress towards regulatory action (i.e. NMS, trading venues, market quality, customer issues).

Commissioner Kara Stein

- Many market participants feel that volatility on August 24th was exacerbated by certain rules – investors and issuers need to be able to count on efficient operation of the market in times of stress.
- Deeply concerned by the relationship of orders types used by retail investors and market volatility on August 24th. Are retail investors uniquely disadvantaged? Does the current market structure favor certain investor types over others?

Commissioner Michael Piwowar

- Pleased by Staff's August 24th research report.
- August 24th provided a test for how our markets perform in times of stress – this event revealed that there is room for improvement.

- **Market Volatility on August 24, 2015**

Presentation on Market Volatility by SEC Staff

- The staff report provides analysis but no recommendations, and the hope is that EMSAC will facilitate the development of next steps.
- August 24th was very different than the Flash Crash of 2010. Aug 24 had very substantial selling prior to the open – Staff does not believe that one can attribute that selling (including related futures) to retail activity. The market open that day was consistent with premarket trading (which was down around 5%). Then there was more (price insensitive) selling, which Staff believes the market handled well. However, the reopening did not go well, and some corporates did not perform well (6 large corporates in particular).
- LULD issues were mostly an issue with exchange-traded products (ETPs) – only 8 products from the S&P 500 triggered a trading pause. Important to keep in mind that the great majority of pauses that occurred on August 24th involved ETPs.
- NYSE Arca imposed price collars on the opening – those later translated into greater volatility once the price collars were lifted. For the pauses that occurred when the market was on its way down – 90% were from market orders. On the way up, more than 90% were driven by limit orders.

Stacey Cunningham, COO, NYSE

- Noted the interconnectedness of issues related to equity market structure and that the Committee should avoid designing changes to accommodate a particular kind of market participant.
- Events of August 24th provided the market with a first opportunity to see the protections that have been implemented post-2010 Flash Crash.
- Highlighted points raised in NYSE's paper on August 24th and the priorities the NYSE believes should addressed in ongoing equity market structure reform.

- Noted that there were two simultaneous events on the morning of August 24th – significant surge of market orders sent before the opening (6 fold increase in market orders on NYSE and NYSE Arca during first half hour of trading) coupled with a broad based withdrawal of liquidity. The combination of these two factors exacerbated the volatility that was observed during the morning trading hours.
- Highlighted four key takeaways from the NYSE research paper: (1) Renewed focus on investor education (i.e., the differences between order types – e.g. stop versus market); (2) LULD refinements; (3) Focus on how market participants have implemented the market access rule and other controls; (4) NYSE will implement their own recommendations in their own rules regarding the opening process and trading halts.

Hubert De Jesus, Co-Head Market Structure & Electronic Trading, Blackrock

- Important to keep the events of the day in context – August 24th was the second highest trading day in history and for the majority of the trading day, the market remained available to investors. ETPs were 37% of the market on August 24th.
- Blackrock's primary theme with respect to its recommendations is the harmonization of trading rules across the equity market trading ecosystem – across stocks, options, futures and ETPs.
- Collective efforts are required across all market participants – issuers play a critical rule as to how the exchange processes and rules contribute to efficient markets.

Frank Hatheway, Chief Economist, NASDAQ

- The August 24th research note by the SEC should not be a one-time event – the Commission should continue to reevaluate that and other less dramatic market events on a continuous basis.
- Market technology on August 24th worked considerably better than on May 6th 2010. Generally speaking, the operational performances of the major trading centers were on target given dramatically increased volumes on August 24th.
- Opposed to the idea that the exchanges should be forced into a one-size-fits-all approach for trading and floor procedures.

Paul O'Donnell, Managing Director and Head of Electronic Trading Product, Morgan Stanley

- Events of August 24th were driven by a number of factors – there was no single cause and there is no single fix. Must remember the state of the global equity markets over the days leading up to the morning of August 24th, which was essentially a global selloff. The NYSE's triggering of Rule 48 deprived market participants of valuable pricing information necessary to feel safe in providing liquidity to the market.
- Recommendations: (1) In order to attract liquidity, exchanges should publish information about imbalances as widely as possible; (2) auctions should wait until imbalances can be offset; (3) price monitoring exception should be built into the auction process; (4) the SIP should publish LULD bands simultaneous with the re-opening, and listing markets should respect these bands

when transitioning from auctions to live trading; (5) regulators should review orders types; and (6) clearly erroneous rules should be amended such that all trades executed within a band should be respected.

Open Discussion

Harmonization of Trading Bands Across Product Ecosystem

- Several panelists expressed support for broadening harmonization of LULD trading protocols to other markets (e.g., futures). Broad agreement that coordination at the regulatory level (e.g., as between the SEC and CFTC) is critical for that harmonization to work.

Harmonization of Trading Protocols (including opening procedures) Across Trading Venues

- Some felt that the opening auction process may be the most important thing to focus on for purposes of understanding what changes should be considered following events like those on August 24th.
- For liquidity providers, the difficulties around pricing ETPs on August 24th related to opening procedures of the exchanges. LULD changes should be considered as well as changes to clearly erroneous rules.
- There was significant discussion on the reopening auction process after a pause due to LULD, including imbalances and repeat pauses after a LULD event. One suggestion was to eliminate the idea of auctions and re-opening auctions completely – need to ask whether there is a more efficient way of re-opening after a pause.
- Exchanges and other trading venue participants were supportive of allowing exchanges to have their own protocols and not adopting a one-size fits-all approach.

Harmonization of LULD and Clearly Erroneous

- Some questioned the continued need for clearly erroneous rules given the implementation of LULD, and felt those rules are antiquated.

- **The Current Equity Market Structure Affecting Customers**

Presentation on Customer Issues by SEC Staff

- Staff provided an overview of its January 26 paper to the EMSAC regarding customer issues.

Jeffrey Brown, Senior VP-Legislative & Regulatory Affairs, Charles Schwab

- Investors should not be deprived of order types that can help them execute a particular strategy, including (in the case of market orders) allowing them to trade at the precise time they want to trade. Firms, including retail firms like Schwab, use internal controls such as trade notifications and other pop up warnings to help investors understand the impacts of orders they

are about to place. This is just one kind of investor education effort – Schwab and other market participants are very supportive of other education efforts that help investors understand order types.
- With respect to payment for order flow (PFOF), PFOF is a system that works to the benefit of clients. Market makers compete and are evaluated on the range of services they provide, primarily execution quality – not on the amount of the fee that they pay.
- It is a very competitive environment for PFOF, and brokerage firms continuously evaluate their market makers. This aggressive competition has lead to pricing that has never been better for retail customers. Forcing order flow back to the exchanges would not be accomplished by banning PFOF.

Frank Childress, Managing Director, Wells Fargo Advisors

- Retail investors have never had it better. The challenge is to manage the events that happen every so often that materially stress the market and cause investors to question the integrity of the market. Spreads in the S&P 500 is 3.5 bps today versus 20 before NMS. Noted that 82% of all orders get price improvement and 90% are executed at the mid or better.
- With respect to investor education, broker dealers take very seriously the educational pieces they make available to their clients.
- With respect to PFOF, the SEC paper correctly notes increasing dollar amounts, but was incorrect insofar as it did not note that PFOF rates took a material shift in 2015 and are no longer trending upwards.
- Industry influence seems to have had a significant impact on PFOF arrangements.
- Enhancing PFOF disclosure is an option – note that most firms are extremely specific as to their disclosures.
- Strong advocate for transparency – Rule 606 have had a material impact on the exceptional execution that retail investors enjoy today. Exclude professional order types (e.g. ISOs).

Dennis Dick, Member – Capital Markets Policy Council, CFA Institute

- Was critical and provided examples of what he referred to as “nominal price improvement” on some order type, leading to the firm effectively setting the price not getting filled.
- Restricting use of stop or market orders would lead to a number of negative issues – better approach would be to required broker dealers to use automated warning systems during times of market stress.
- Communicating with and educating investors regarding the consequences of a particular order type is paramount.

Christine Parlour, Professor, UC Berkeley

- Agreed with Dick’s comments but focused primarily on two issues – (1) Interested in “all in cost” to retail investors – do commissions flow in such a way that retail investors are better off; and

(2) What would the world look like if PFOF did not exist? Liquidity provision would probably be more efficient, as PFOF reduces competition on liquidity provision.

Open Discussion

PFOF

- Strong opinions expressed (particularly by market making firms) as to the benefits to the market and investors of PFOF and the consequences of banning the practice. Some expressed the strong view that making firms compete aggressively for executions and that the current execution quality has never been better. Investors receive .3 to .4 cents per share average price improvement on market orders under 10,000
- Key questions are: does PFOF create a conflict that can be managed or should it be banned? Relatedly, should off-exchange trading be restricted by some kind of trade-at rule? The focus needs to be on price discovery, not providing a better deal to a particular investor class.

Disclosure of Execution and Routing

- There was broad support for transparency, and several participants argued for enhanced 606 disclosure to show routing by venue and execution quality by venue. One possible remedy vis a vis disclosure could be a non-aggregated 606 enhancement looking at venue by venue.

Consideration of Changes to Availability of Stop Orders / Market Orders

- Several firms, including market making and retail brokerage firms noted that from a client's perspective, important to remember that market and stop orders are very important to investors and retail investors should not be deprived of them – more investor education should be considered, but a categorical ban against those orders would be dangerous.
- Financial services firms should have more accountability *ex ante* with respect to how they enter orders.
- With respect to stop loss orders and market orders – consider what scale of effort would be needed to effectively educate investors about the differences between these kinds of orders. Instead of getting rid of these orders, could you balance the way in which these orders are used in stressed trading situations?

- **Report of EMSAC Subcommittees**

Kevin Cronin, Invesco, introduced the progress to date on the Reg NMS Subcommittee.

- <u>Priority #1</u>: Access Fees. They recognize that there are certain market participants that are not included in the full Committee, including retail, NYSE and Nasdaq. They are working to extend invitations to NYSE and Nasdaq, particularly from the point of view of getting input on access fees and other related issues. There will be an in person meeting next week in New York. Minutes will be reflected on the EMSAC website. <u>Priority #2</u>: Market Data. Some of these issues will be in the governance committee – others in the NMS committee. Priority #3: Rule 611. Will continue to exam it and would look to invite specific participants.

Eric Noll, Convergex, introduced the progress to date on the Market Quality Subcommittee

- Have held two meetings thus far. Much is about process and getting the right people in front of the Subcommittee. Have extended invitations to the large exchanges and are hoping for their participation. Focused on using August 24th as a launch pad for the larger discussion. Also spending time on LULD and clearly erroneous and how those two constructs should work together. Among other questions, they are considering what it means to be a market maker – what should one's obligations and rights be?

Richard Ketchum, FINRA, introduced the progress to date on the Trading Venues Regulation Subcommittee

- Subcommittee has met twice. Broad objective is to evaluate the existing trading venue construct – more specifically, (1) Exchange versus ATS issues and the comparative impact of both, and (2) NMS plan governance. Meetings to date have looked at the Reg ATS proposal – consensus of Subcommittee was that the proposal hit the mark in terms of balancing the competing interests. Broader issues of the regulatory framework for exchanges versus regulatory requirements for ATSs engaged in similar activities to exchanges. Also looking at NMS plan governance – focus is on the question of industry participation on the NMS plan governance committees. Question is how to provide the most useful input for buy and sell side. No uniformity for selection process, approach and transparency. Have not reached a final conclusion on industry participation.

Manisha Kimmel, Thomson Reuters, introduced the progress to date on the Customer Issues Subcommittee

- Have met three times – setting the context for retail investor concerns. Have reviewed information regarding investor confidence, attitudes and other issues. Looking at 605/ 606 (including the inclusion of odd lot orders in 606 reports and excluding professional orders). Investigating the role of investor choice, investor education. Will be seeking input from retail broker-dealers at future meetings.

DeltaStrategy Group