



SEC EQUITY MARKET STRUCTURE ADVISORY COMMITTEE MEETING

OVERVIEW

For questions on the note below, please contact [Graham Harper](#) or [Kwon Park](#) at (202) 547-3035.

Yesterday, the SEC held a [meeting](#) of the Equity Market Structure Advisory Committee (EMSAC) to discuss and consider (1) the Market Quality Subcommittee's [recommendations relating to market quality](#); (2) the Customer Issues Subcommittee's [recommendations relating to customer issues](#); (3) the Regulation NMS Subcommittee's status report to the Committee; and (4) the Trading Venues Regulation Subcommittee's status report to the Committee.

Key Takeaways

- The Market Quality Subcommittee proposed recommendations that would modify the current limit up/limit down (LULD) regime, change the reference index for measuring market decline to the S&P 500, and reduce the market decline thresholds. The Subcommittee also considered further refinements to market-wide circuit breakers.
- The Customer Issues Subcommittee's recommendations proposed an investor confidence survey and modifications to Rules 605 and 606 to provide further execution quality and order handling disclosures. Some Committee members disagreed as to whether the investor survey was necessary.
- At the next EMSAC meeting, the Market Quality and Customer Issues Subcommittees will make final recommendations to the full Committee for a vote. If approved, the recommendations will be submitted to the SEC for further consideration.

SUMMARY

Opening Statements

[Chair Mary Jo White](#)

- The Market Quality Subcommittee's proposed recommendations focus on three topics: 1) the NMS plan to address extraordinary volatility, commonly referred to as the LULD plan; 2) market-wide circuit breakers; and 3) the market opening procedures.
- After volatile market events, several changes were made: 1) the reference index used for measuring market volatility was changed from the Dow Jones Industrial Average to the S&P 500

Index; 2) the trading halt duration was shortened to 15 minutes; and 3) the market decline thresholds were reduced to 7, 13, and 20%.

- The Committee will consider recommendations to further refine market-wide circuit breakers.
- The Customer Issues Subcommittee's recommendations focus on two topics: 1) the creation of an investor sentiment benchmark; and 2) additional enhancements to Rules 605 and 606.

Commissioner Michael Piwowar

- Promoting investor confidence is not part of our core mission and is a nebulous concept, and, most importantly, focusing on investor confidence creates the wrong incentives.
- Believes the Commission should be encouraging a healthy dose of investor skepticism in order to fulfill our investor protection mandate. The Commission should urge investors to ask questions about, for example, how their orders are treated and whether that is consistent with their personal investment goals and decisions.
- The recommendation for investor testing would be valuable not because it could improve investor confidence, but because it could facilitate investors making informed choices about investment venues, strategies, and products.

Commissioner Kara Stein

- Market quality concerns exist for small to mid-size companies. It is critically important for these companies to have access to capital so they can continue to grow. Also, monitoring investor confidence is important.

Market Quality Subcommittee Recommendations on Market Quality

Eric Noll, Convergex Group

- With respect to LULD, the Subcommittee identified three areas with room for modifications:
 1. Recognizing that the auction process following a LULD has not worked as envisioned. While LULD prevents stocks from runaway prices, the re-opening process does not operate in a way that allows securities to discover new, fair trading prices.
 2. Conforming clearly erroneous execution rules to LULD bands; and
 3. Establishing mean reversion around LULD bands, allowing stocks to return to their original trading prices without undue restriction.
- Also, market-wide circuit breakers should be widened and market openings across venues should occur as close to the 9:30am opening as possible. Anything delaying the opening brings uncertainty and volatility to the marketplace.

James Angel, Assistant Professor, Georgetown University School of Business

- LULD does prevent runaway prices but can still be improved, as the re-opening process has been problematic. Auctions are vulnerable to gaming, manipulation, and liquidity. Potential

improvements include gradually widening pricing bands rather than using a trading halt and harmonizing the clearly erroneous execution rules with LULD.

- Market-wide circuit breakers are dangerously defective – if a market is under stress, the last thing it needs is more stress. The trigger should be based on the open price – there should be close coordination with the derivatives markets, and a rethinking of the re-opening process.
- There are things that can be done to improve liquidity on small cap companies. Small cap companies contemplating going public face litigation risks, compliance burdens, and market structure issues.

Stacey Cunningham, COO, NYSE Group

- The primary priority of the re-open process should be on the display of liquidity. Market maker programs are rule-based mandatory obligations, and in exchange for that risk, market makers are rewarded with a set of incentives.
- Extending the limit state warrants extensive review before finalization.
- Primary markets are committed to adopting a standardized approach to LULD and prohibiting the market center from resuming securities trading until it re-opens.
- Re-tiering requires technology changes by the exchanges and the SIP.
- The Commission should not emphasize markets opening as close to 9:30am as a market objective – issuers should choose what issues matter most to them.

Venu Palaparthi, Senior V.P. – Compliance, Regulatory, and Government Affairs, Virtu Financial

- Anything to extend the limit state is more beneficial than a halt from a market makers perspective, as it helps us continue to stay in the market and generate prices. Trading halts are disruptive to the price discovery process.

John Zecca, Senior V.P. – MarketWatch, NASDAQ

- It is important that all stock trading opens as close to 9:30am as possible.
- Market-wide circuit breakers should be deployed only when absolutely needed. Using the S&P introduces the potential risk of contagion.
- NASDAQ is disappointed in the lack of improvements for small and mid-size companies. A one-size-fits-all market structure is not recommended.

Open Discussion

Richard Ketchum, FINRA: Any concerns on the futures limit type approach? *Cunningham:* We are not sure how orders will resume and be processed coming out of the re-opening period; *Angel:* Remember we also have pre-opened trading. Prices discovered at 9:30am are probably very accurate. A one-size-fits-all rule will not apply in all situations and at some point we need to apply market judgment.

Working off the open is a lot better than working off the closing period; *Mecane:* The Commission should closely monitor the tick-size pilot before proposing another recommendation.

Joe Ratterman, BATS Global Markets, Inc.: Support extending the limit state for two minutes or longer, but an auction may be the only option to discover the right price. The new exchange effort to harmonize and standardize should be applied to the market before proposing other ideas.

Joseph Mecane, Barclays PLC: Are people willing to participate in the pre-opening state for longer periods of time? *Noll:* The timing was subject to controversy, but unlike the auction process where everyone halts, as long as there are indications of interest and bid/offers, the market will re-open for trading.

Chester Spatt, Carnegie Mellon University: With clearly erroneous trades, the problem has been ruling trades as clearly erroneous that are ex ante determined not erroneous. Having as much clarity on execution is important because of the ex ante impacts to liquidity.

Kevin Cronin, Investco Ltd.: The Commission should work to ensure adequate information is available.

Gary Stone, Bloomberg Tradebook LLC: What is the revert price or the snap back price under the mean reversion proposal? *Noll:* Reference prices used to trigger the band is where stocks should be allowed to go without interference.

Customer Issues Subcommittee Recommendations on Customer Issues

Manisha Kimmel, Thomson Reuters

- Payment for order flow (PFOF) is being discussed by the Subcommittee. The order handling disclosure proposal warrants additional modifications to Rule 605 and 606.
- The Subcommittee makes the following recommendations:
 - Propose an investor confidence survey specific to market structure, disclosure, volatility, and other related measures. The survey should also be clear and comprehensible.
 - Modify Rules 605 and 606 to provide meaningful execution quality and order handling disclosures. The SEC should be the central place where these reports are available and should be incorporated in the SEC data visibility tool.
 - Expand the scope of Rule 605 to allow the use of third party vendors and recommend that calculations be based on SIPs or proprietary data feeds.
 - Modify Rules 605 and 606 to reflect changes in market structure (i.e. segregate marketable limit orders from non-marketable limit orders).
- The exact recommendations on enhanced retail order routing are forthcoming.

Bill Alpert, Senior Editor, Barron's

- Broker-dealer (BD) disclosures need to be comparable among its competitors. Disclosure improves BD behavior.
- The proposed modifications to Rules 605 and 606 look good. Additional disclosures should be available to the public, be non-proprietary, and remain online for more than three years.

Frank Hatheway, Senior V.P. & Chief Economist, NASDAQ

- PFOF is important - the Subcommittee will hold off on a recommendation until reviewing all comments.
- The mere existence of reports provide market discipline that the Commission envisions in Rules 605 and 606. Based on the Subcommittee's review of these reports, it was unclear whether they continued to provide the level of transparency for superior execution quality and routing. While the tick-size pilot should not serve as a template for updates to 605 reports, it should be very instructive on how to obtain and process trade data.
- The proposal improves granularity of 605 reports, but the Commission should consider the usefulness of data produced by the pilot.
- The Commission should study what factors drive their interest into the markets – I believe investors are driven by factors other than market structure.

Chris Nagy, Director, Healthy Markets Association

- Modernizing Rule 606 could promote competition, reduce conflicts of interest, and promote better BD behavior.
- The Commission should abandon the artificial distinction of institutional versus retail orders and apply its rules consistently. The results for both orders should be the same – best execution for the investor.
- Centralized reporting of historical data will help reduce incorrect and misreporting. The Commission should adopt flexible standards and recognize that specific reporting structures will be outpaced by technology advancements.
- The indications of interest should be included but should be reported separately from orders to cut down on noise. Urge the SEC and the Committee to include disclosures on options markets.

Open Discussion

Mecane: The industry is still formulating views on different ways to distinguish 606 reports. There are inconsistencies for orders of certain customers and it is too early to know how that recommendation will look.

Stone: The Commission should focus its resources on MIDAS and other correlated data collection efforts. *Nagy:* CAT does not help collect data on fee arrangements and other disclosures required under Rule 606, and does not provide many quantitative metrics for comprehensive analysis. Individual investors need for the SEC to provide the data and the visualization tools to understand the data.

Ketchum: What should the Commission consider to address issues to its initial proposal? *Nagy:* The proposal is very comprehensive. The centralized reporting structure is a key consideration to foster modernization on a fairly regular basis - of statistics which have been lacking.

Pratt and Maureen O'Hara, Cornell University and Investment Technology Group Inc.: Skeptical as to how the investor survey of confidence will inform the work and objectives of the Commission – the recommendation is broad as it relates to investor confidence.

Nancy Smith, AARP Inc.: We need clarification on investor impacts to participation in stock markets and the tradeoffs.

Andrew Lo, MIT and AlphaSimplex Group: The idea behind the survey is to ask market end-users on whether they believe markets are fair equitable and efficient. With respect to cost, the SEC can partner with universities or firms to conduct these surveys.

Brad Katsuyama, IEX Group Inc.: The more we can standardize inputs, the more value we can derive from information collected.

Regulation NMS Subcommittee Status Report

Kevin Cronin

- Moving forward, the Subcommittee will focus on the order protection rule, locked and crossed markets, subpanic pricing, and block trade exemptions.
- Also, the Subcommittee will focus on competition, value, and pricing of SIPs, and PFOF. The Subcommittees may have to be restructured to accommodate future topics.

Trading Venues Regulation Subcommittee Status Report

Richard Ketchum

- The general consensus is to move forward in the area of exchange liability limits and the sufficiency of limits. The Subcommittee continues to discuss regulatory immunity, but is not prepared to make a formal recommendation at this time.
- Additionally, the Subcommittee is focusing on potential conflicts of interest at ATs and BDs, and to enhance transparency in broker order handling. We are studying the functioning and the utility of consolidated market data feeds and ways to more clearly understand the operation of SIPs.
- Finally, the Subcommittee plans to hold a panel discussion with select market participants on the Europeans pursuit of a competing SIP model.